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NO. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

KENNETH R. CUNNINGHAM, SALVADOR ESPARZA, EDWARD F. FRITCHER, WILFORD H. HAIRELL AND A. MITCHELL ROBERTSON,
Petitioners

v.

RAYMOND J. DONOVAN, Secretary of Labor,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

C. LELAND HAMEL *
2300 Citicorp Center
Houston, Texas 77002
(713) 658-8888

MORTON L. SUSMAN **
2400 Republic Bank Center
Houston, Texas 77002
(713) 222-1621

* Counsel of Record for Petitioners Esparza and Fritcher.

** Counsel of Record for Petitioners Robertson, Hairell, and Cunningham.

March 1, 1984

Alpha Law Brief Co., Inc.—3606 Parkersburg—Houston, Texas 77036—223-3003

QUESTIONS PRESENTED

1. Whether the court of appeals erred in interpreting and applying ERISA Section 3(18)(B) by holding that the petitioners could not establish an exemption under ERISA Section 408 to the prohibited transaction rules under ERISA Section 406 without showing that they acted prudently under ERISA Section 404.

2. Whether the court of appeals erred in requiring petitioners to prove they did not violate ERISA Section 404 rather than requiring the Secretary to prove that petitioners did violate such section.

3. Whether the court of appeals erred in reaching a legal conclusion opposite that of the district court's where the district court's conclusion was based on findings that were not set aside as clearly erroneous.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

C. Leland Hamel on behalf of Salvador Esparza and Edward F. Fritcher, and Morton L. Susman on behalf of A. Mitchell Robertson, Wilford H. Hairell and Kenneth R. Cunningham, hereby petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

---

* The other parties to the proceeding before the court of appeals were L. J. Carter and Mark W. Perrin, who are not parties to this petition.

OPINIONS BELOW

The opinion of the court of appeals (App. A) is reported at 716 F.2d 1455. The opinion of the district court (App. D) is reported at 541 F. Supp. 276.

JURISDICTION

The judgment of the court of appeals (App. A) was entered on October 17, 1983. A petition for rehearing was denied on December 2, 1983 (App. B). Petitioners' motion for stay of mandate pending the determination of this petition was denied on December 22, 1983 (App. C). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The decision of the court of appeals and this petition involve the interpretation, application and relationship of the following statutes, the full text of which is reproduced in Appendix E:

1. Section 3(18)(B) of the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. § 1002(18)(B), provides:

> (18) The term "adequate consideration" when used in part 4 of subtitle B of this subchapter means . . . (B) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

2. Section 404(a)(1) of ERISA, 29 U.S.C. § 1104 (a)(1), provides in part:

> (a)(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> * * *
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> * * *
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

3. Section 406(a) of ERISA, 29 U.S.C. § 1106(a), provides in part:

> (a) Except as provided in section 1108 of this title:
>
> (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—
>
> (A) sale or exchange, or leasing, of any property between the plan and a party in interest;
>
> * * *

> (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
>
> * * *

4. Section 408(e) of ERISA, 29 U.S.C. § 1108(e), provides in part:

> (e) Sections 1106 . . . of this title shall not apply to the acquisition . . . by a plan of qualifying employer securities . . . —
>
> (1) if such acquisition . . . is for adequate consideration. . . .
>
> * * *

STATEMENT OF THE CASE

This is a case of first impression which involves the interpretation of key provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") pertaining to the purchase and valuation of employer securities by fiduciaries of an employee stock ownership plan ("ESOP") of a closely-held company.

This litigation began when the Secretary of Labor (the "Secretary") sued the petitioners in the United States District Court for the Southern District of Texas. The Secretary contended that the petitioners had breached their fiduciary duties to an ESOP by paying more than "adequate consideration" for the stock of the employer company, Metropolitan Contract Services, Inc. ("MCS"). The case was tried before the district court which entered judgment in favor of petitioners.

In late 1975, the board of directors of MCS voted to establish an ESOP, effective July 1, 1975, for the em-

ployees of MCS. The MCS ESOP was established to make investments principally in MCS stock, purchased with tax-deductible contributions from MCS to the ESOP trust. The ESOP enabled the employees of MCS to obtain an equity in MCS at the company's sole expense. The MCS ESOP was fully approved by the IRS as a qualified stock bonus plan. The Secretary had not then, nor has he yet promulgated regulations to guide ESOP fiduciaries in determining the fair market value of employer securities of a closely-held company to be purchased for an ESOP.

In August, 1976 and February, 1977 the MCS ESOP purchased 1440 and 5000 shares of MCS stock for $200 a share from Mr. Cunningham, the sole shareholder of MCS. The second transaction was financed by a bank loan to the ESOP trustee, which was paid off entirely by November, 1977 by contributions to the ESOP by MCS. When these transactions occurred, petitioners were members of MCS ESOP's administrative committee. As such, they were fiduciaries under ERISA, charged with paying no more than the statutory "adequate consideration" as defined in ERISA Section 3(18)(B).

In January, 1980 the Secretary filed this suit against petitioners alleging, with respect to the two stock transactions, that the petitioners violated the general fiduciary responsibility standards of ERISA Section 404 by failing to follow procedures necessary to determine fair market value and by causing the plan to pay Cunningham more than "adequate consideration" for his stock. The Secretary also alleged that petitioners violated ERISA's Section 406 prohibited transaction rule which declares the transactions in question to be *per se* violations unless

"adequate consideration" is paid under the exemption in ERISA Section 408.

The trial began December 6, 1981 and lasted six days. The only witnesses to testify in person at trial were the fiduciaries, their expert, MCS's accountant and the Secretary's expert. The district court found for the petitioners holding that they had not paid more than adequate consideration for the MCS stock, that each petitioner conducted himself in good faith with dedication to the ESOP participants and beneficiaries, and that an appraisal relied on in part by petitioners was a reasonable approximation of the value of the stock at the times the stock was purchased by the ESOP. The district court rejected the testimony of the Secretary's expert as arbitrary, unreliable, and not persuasive and found that the expert acted with an obvious prejudice in favor of attaining a valuation to support the Secretary's theory. Based on its findings, the district court concluded that petitioners' reliance on the appraisal (performed by an independent investment banking firm) coupled with their independent assessment of MCS's potential was reasonable and prudent. The district court also concluded that petitioners met their burden of proving an exemption from the prohibited transaction rules by proving that the consideration paid for the stock was "adequate consideration".

The court of appeals reversed, holding that the district court's legal conclusion that petitioners acted prudently was erroneous. Specifically, the court of appeals disagreed with the district court that petitioners were prudent in relying to any extent on the appraisal for the reason that petitioners failed to show they had investigated and evaluated the effect on the value of MCS stock of several events after the appraisal date, that is: MCS's failure to achieve

projected revenues during the fiscal year predicted; and the adoption of the ESOP by MCS.

The court of appeals reasoned that if the petitioners could not show they acted prudently, they could not show they paid "adequate consideration". Thus, the court of appeals reasoned, because petitioners could not show prudence (with respect to the use of the appraisal without investigating the effect of certain subsequent events), they were in violation of both Sections 404 and 406.

The court of appeals directed that on remand the district court should consider appropriate relief to award the Secretary for petitioners' lack of prudence under ERISA Section 404 and for their failure to prove they paid no more than "adequate consideration" for Mr. Cunningham's stock.

REASONS FOR GRANTING THE PETITION

The Decision Below Presents Important Federal Questions with Potential for Significant Adverse Impact on the Establishment of Employee Stock Ownership Plans in Closely-Held Companies Contrary to the Intent of Congress.

This is the first case which considers the meaning and application of Sections 3(18)(B), 404, and 408 of ERISA as these provisions pertain to the valuation of closely-held employer securities by fiduciaries with a view to acquiring them for an IRS qualified ESOP.[1] Judicial

1. ". . . [U]ntil the present case, no court has had occasion to interpret or apply Section 3(18). It is with some trepidation that we undertake to be the first to do so, unaided by the views of others, for we must satisfy the demands of Congressional policies that seem destined to collide". Court of Appeals op., 716 F.2d 1455, 1466 (App. A, p. 20a).

evaluation and review of the opinion below is necessary because the opinion raises questions of national importance which will have a profound impact upon the viability of employee stock ownership plans in closely-held companies. If not set aside, the decision below will significantly deter and discourage owners of closely-held companies from establishing ESOPs, and limit the opportunity for employees of those companies to obtain equity in their employer company as a benefit from their labor.

Not only is there no previous case authority on the issue of standards to apply in the valuation of closely-held stock for ESOP purposes, there is no specific regulatory guidance from the Secretary, notwithstanding the fact that Congress intended such guidance.[2]

Thus, these petitioners have been left to follow the literal wording of Section 3(18)(B) and have been left to guess how a court would ultimately interpret this section and evaluate their conduct.[3]

The absence of regulatory guidelines in this area has been the subject of comment in a report of the Comptroller General of the United States dated June 20, 1980.[4] Included in that report is the Labor Department's re-

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2. ". . . [T]he statute itself makes clear that Congress intended for the Secretary to flesh out the standards for fiduciaries to follow in establishing . . . ("adequate consideration"). Court of Appeals op., 716 F.2d 1455, 1466 n.22 (App. A, p. 20a).

3. "It should not be necessary to point out that the appropriate means of implementing that legislative intent is by way of an orderly regulatory proceeding, 29 U.S.C. § 1135 (1976), not by attempting to convince a court to short-circuit the process". Court of Appeals op., 716 F.2d 1455, 1466. (App. A, p. 20a).

4. Comptroller General's Report to the Committee on Finance, United States Senate, June 20, 1980, HRD-80-88, *Employee Stock Ownership Plans: Who Benefits Most In Closely-Held Companies?*

sponse in which it concurs in the GAO recommendation to develop and promulgate more specific criteria and guidelines for valuing stock of closely-held companies, and comments on the difficulty of developing a method of determining "adequate consideration".[5]

There is no question that the valuation of closely-held stock for ESOP purposes is a difficult and inexact endeavor. The Labor Department has recognized it. The district court has commented on it.[6] And the court of appeals also commented on it in its rejection of the Secretary's view that a revenue ruling pertaining to valuations for estate and gift tax purposes should be followed in this case.[7]

The absence of guidelines is all the more reason to focus on the good faith of the fiduciaries. There is no allegation in this case of deliberate, knowing or intentional wrongdoing, evil motive, or self-dealing.[8]

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5. The letter from the Department of Labor to the U.S. General Accounting Office with enclosures is Appendix F (pp. 79a-85a). It was written two months after this suit was filed by the Secretary.

6. "Evaluation of the stock of a closely-held corporation is an inexact endeavor. . . . [T]he unique circumstances of a transfer of shares to an employee benefit plan require divergence from usual evaluation techniques." District Court op., 541 F. Supp. 276, 284. (App. D, pp. 59a-60a).

7. "Judicial adoption of this revenue ruling is no substitute for the regulations the Secretary has never promulgated; we are unwilling to hold that ERISA fiduciaries who fail to follow it jot and tittle have breached their duties.[37] Appraisal of closely-held stock is a very inexact science; given the level of uncertainty inherent in the process and the variety of potential fact patterns, we do not think a court should require fiduciaries to follow a specific valuation approach as a matter of law under Section 3(18)." Court of Appeals op., 716 F.2d 1455, 1473. (App. A, pp. 35a-36a). (Footnote in the original omitted).

8. Petitioners were the principal employees of MCS. They received no special compensation for their service on the administrative com-

The focus in the court of appeals' analysis is on the conduct of the fiduciaries in investigating the value of the stock to be purchased, not on whether adequate consideration was paid. The district court concluded that adequate consideration was paid, and this conclusion has not been set aside directly by the court of appeals. Rather, the court of appeals has determined that the "adequate consideration" exemption can not be shown if the fiduciaries fail to show they measured up to the general fiduciary standards in Section 404. It is this analysis by the court of appeals that is erroneous, and leads to a result that conflicts with Congress' intent.

A. Congress' intent in enacting ERISA has been thwarted by the decision of the court of appeals requiring ESOP fiduciaries to show prudence in order to claim the good faith exemption to a prohibited transaction.

Congress expressed its strong desire to promote ESOPs in the Tax Reform Act of 1976 in the following language:

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mittee of the ESOP. The four petitioners other than Cunningham received none of the consideration in the stock sales. Cunningham did not vote on the proposal that the ESOP purchase his stock, even though he was a committee member and was present during discussions about purchasing the stock and what amount to pay for it. As a member of the MCS ESOP Administrative Committee, he inadvertently violated a MCS ESOP plan provision prohibiting a committee member from "participating" in the transaction, and thus was found by the court of appeals to have violated Section 404. Court of Appeals op., 716 F.2d 1455, 1468. (App. A, p. 25a). Cunningham does not complain of this finding in this petition, although he obviously had to participate on the sale side of the transactions since he owned the stock proposed to be purchased by the ESOP. Since he did not vote on the stock purchases, he takes the position that his conduct did not amount to self-dealing.

INTENT OF CONGRESS CONCERNING EMPLOYEE STOCK OWNERSHIP PLANS

> The Congress, in a series of laws (the Regional Rail Reorganization Act of 1973, *the Employee Retirement Income Security Act of 1974*, the Trade Act of 1974 and the Tax Reduction Act of 1975) and this Act *has made clear its interest in encouraging employee stock ownership plans* as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth *and of bringing about stock ownership by all corporate employees.* The *Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by* regulations and *rulings* which treat employee stock ownership plans as conventional retirement plans, *which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans* * * *.[9] (Emphasis added)

The decision below is the type of ruling that Congress was concerned about. Petitioners believe Congress intended to structure the exemption so that one claiming an exemption would not have to prove prudence in determining whether "adequate consideration" was paid in a prohibited transaction, and that the court of appeals erred in engrafting the Section 404 standard onto the definition of "adequate consideration" in Section 3(18)(B).

The definition of "adequate consideration" as found in Section 3(18)(B) resulted from a carefully structured compromise between the differing views of the House and the Senate. The House version that went to the Senate

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9. Pub. L. 94-455, Title VIII, § 803(h), October 4, 1976, 90 Stat. 1590, 26 U.S.C. § 4975.

defind "adequate consideration" to mean ". . . the fair market value of the asset as determined in good faith by the trustee or administrator pursuant to the terms of the plan".[10] Compliance with regulations of the Secretary was not part of the definition of "adequate consideration". The Senate version of the House bill excepted from prohibited transactions any action authorized by the Plan document and otherwise in accordance with the exclusive benefit and prudent man rules.[11] The differing versions of the bill were resolved by the Committee of Conference and the resolution of the disagreement is reported in the Joint Explanatory Statement of the Committee of Conference.[12]

Resulting from the compromise was the current language which no longer *specifically* exempts (as did the Senate version) a prohibited transaction such as this only if it comports with the standards of the prudent man and exclusive benefit rules, but does include the requirement (supplementing the House version) that the fiduciaries act in accordance with regulations to be published by the Secretary.

The legislative history reports the resolution of differences as follows:

> While the House bill would have permitted the transfer of assets between the plan and a party-in-interest as long as the transfer was for adequate consideration, the Senate view has been that the adequate consideration test may not be sufficient protection against the temptations for wrongdoing inherent in

10. H.R. 2, as amended by the Senate, March 4, 1974, p. 12.

11. *Id.* at 532.

12. Senate Conference Report No. 93-1280, 2nd Sess., August 12, 1974.

these kinds of transactions, and the conferees agreed to accept the Senate view on this issue.[13]

It is submitted that the Senate view (that the adequate consideration test was not sufficient) was accommodated by adding compliance with the Secretary's regulations as a part of the definition of "adequate consideration".

In view of the disagreement, if the Joint Conference agreed that fiduciaries should have the burden of showing prudence to prove payment of "adequate consideration", that term easily could have been defined as "the fair market value as determined under the reasonably prudent man standard, and in accordance with the terms of the plan and the regulations of the Secretary". However, the Joint Conference did not do so.

That Section 3(18)(B) was not intended to incorporate the prudent man rule becomes all the more clear when one focuses on Section 3(18)(A). In defining what constitutes "adequate consideration" for a security for which there *is* a generally recognized market, "good faith" is not mentioned. If the securities in question had been listed on the New York Stock Exchange, and the fiduciaries had paid the price prevailing on that exchange, no one would seriously contend that adequate consideration had not been paid under Section 3(18)(A). This would have been so even if the fiduciaries had acted imprudently in buying such securities. In such case, the fiduciaries would not have been liable under Section 406 (because having paid "adequate consideration" they would have established a Section 408 exemption), but nevertheless could have been liable under Section 404 for acting imprudently. Section 3(18)(A) makes it clear that

13. 1974 U.S. Code Cong. & Ad. News 5186.

in defining "adequate consideration" Congress intended to concentrate on the end result, i.e. whether fair market value was paid or not? Congress did not intend to focus on the conduct of the fiduciary to ascertain whether it was within the prudent man standard, because fiduciary conduct was addressed under Section 404. Petitioners contend that the reference to "good faith" in Section 3(18)(B) was not intended to incorporate the prudent man rule but was intended to be utilized as a defense to a charge that fair value was not paid.

The error of the court of appeals is its conclusion that these petitioners could not, as a matter of law, prevail on the exemption question unless they first showed they acted prudently in investigating all the factors that might affect value. It is error because Congress intended to prohibit sales of employer securities to an ESOP only if the amount paid by the ESOP exceeded adequate consideration. If the adequacy of the consideration is proven, the fiduciaries cannot be sanctioned under Section 406. However, their general conduct is still governed by Section 404. If the Secretary nevertheless felt the fiduciaries acted imprudently (e.g., in failing to investigate all possible factors that could have a negative impact on value) even though adequate consideration was paid, then the Secretary could go forward and attempt to prove imprudence, and obtain appropriate sanctions if he prevailed.

Thus, the ultimate focus of Section 3(18)(B) is on value. The ultimate focus of Section 404 is on conduct. The distinction is important for two reasons.

First, valuation of closely-held stock for ESOP purposes is extremely difficult. Rather than subject fiduciaries to being second-guessed after the fact on the *value* issue,

Congress intended only that fiduciaries come forward with evidence to prove they acted in good faith and complied with regulations and plan provisions. This burden is more easily understood and met by those individuals who are likely to be serving on an ESOP committee of the typical closely-held company. The ordinary working man can understand being held financially liable for failing to act in good faith, to follow the Secretary's regulations, and to follow his company's ESOP plan provisions. But his being charged or held accountable for what some bureaucrat or court might later view as imprudent, and being held accountable financially, is a great risk and likely to deter him from being willing to serve as a fiduciary.

In petitioners' view the obligations under Sections 404 and 408 are separate. Even if fiduciaries show they acted in good faith and paid "adequate consideration", the Secretary might assert their imprudence under Section 404 which, if proven *by the Secretary,* would subject the fiduciaries to sanctions, non-monetary ones, of course, where the fiduciaries have proven adequate consideration.

Second, the burden of proof is on different parties, depending upon the section involved. Fiduciaries have the burden of proving value. The Secretary has the burden of proving imprudent conduct.

B. The Secretary has the burden of proof on the prudence issue, and the court of appeals erroneously shifted this burden to petitioners, contrary to the intent of Congress.

The court of appeals' analysis shifts the burden of proof on the Secretary with respect to a Section 404

violation to the fiduciaries claiming a Section 408 exemption.

The court of appeals placed the burden on petitioners to show they acted prudently. Petitioners were charged with imprudence under Section 404 on two bases: causing the payment of more than adequate consideration; and failing to follow procedures necessary to determine fair market value.

Petitioners' understanding of the opinion of the court below is that because they failed to prove they prudently investigated the value of the stock, they could not claim the "adequate consideration" exemption. This understanding is based upon, *inter alia*, the following excerpts from the opinion:

> ". . . [W]e hold that the ESOP fiduciaries will carry their burden to prove that adequate consideration was paid *by showing* that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing". (emphasis supplied)[14]
>
> ". . . [I]n our view, the (petitioners) have not shown facts that establish their prudent investigation of the price they paid for MCS stock."[15]
>
> ". . . [W]e do not agree that their testimony establishes an investigation sufficient to warrant continued reliance on the Rotan Mosle appraisal."[16]

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14. Court of Appeals op., 716 F.2d 1455, 1467-1468 (App. A, p. 24a).

15. *Id.* at 1469 (App. A, p. 27a).

16. *Id.* (App. A, p. 28a).

Petitioners have the burden of showing that they caused the ESOP to pay no more than "adequate consideration" in the purchase of MCS stock.[17] However, petitioners contend that the burden of proof is on the Secretary to establish that they breached their fiduciary duties under Section 404.

Under general principles of trust law, where no self-dealing is involved on the part of the trustee, the plaintiff has the burden of proving that the trustee breached his fiduciary duties.[18] It is only when the trustee deals with the trust assets for his own account or otherwise derives benefit therefrom does the burden of proof on the issue of breach of fiduciary duties shift from the plaintiff to the trustee. In the case at bar, four of the petitioners had no personal interest in the purchase of MCS stock and Mr. Cunningham did not vote; the petitioners, exclusive of Mr. Cunningham, did not receive any of the consideration paid by the ESOP.[19] In other words, those that voted had no interest; he who had an interest didn't vote. Since no self-dealing on the part of petitioners was involved, the Secretary had the burden of proving that each of the petitioners violated Section 404.

The Secretary alleged violation of Sections 404 and 406 in separate counts. If the court of appeals is correct, the Secretary's burden as to the Section 404 count is shifted to petitioners even though the statutory exemption they claimed related to the alleged Section 406 violation.

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17. *Marshall v. Snyder*, 572 F.2d 894, 900 (2nd Cir. 1978).

18. *Bellis v. Thal*, 373 F. Supp. 120 (E.D. Pa. 1974) *affirmed* 510 F.2d 969 (3rd Cir. 1975).

19. See n. 8, *infra*.

Where Congress intended the burden of proof on the issue of prudence to shift it used specific language. For example, Section 404(a)(1)(C) contains the words "clearly prudent", and the Joint Conference report explains that by use of the term "clearly prudent", it was

> "intended that in an action for plan losses based on breach of the diversification requirement, the plaintiff's initial burden will be to demonstrate that there has been a failure to diversify. The defendant then is to have the burden of demonstrating that this failure to diversify was prudent."[20]

By engrafting the prudence requirement onto the definition of "adequate consideration", the court of appeals has shifted the burden of proof on the prudence issue from the Secretary to the petitioners. The words "clearly prudent" or the word "prudent" do not appear in Sections 3(18) and 408. The absence of such words underscores petitioners' contention that this court erred in engrafting the prudence requirement onto the "adequate consideration" standard, and indicates Congress did not intend the burden of proof on the prudence issue to shift from the Secretary to petitioners.

C. Review by this court is necessary because if the decision below is left standing the Secretary will have no incentive to promulgate regulations contrary to Congress' intent.

The Section 3(18)(B) definition of "adequate consideration" contemplates that the Secretary will promul-

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20. Joint Explanatory Statements of the Committee of Conference on H.R. 2, 93rd Cong., 2nd Sess., H.R. 93-1280 at 384 (August 12, 1974).

gate regulations to guide fiduciaries in valuing closely-held stock to be sold to an ESOP. In the nine years after ERISA's enactment, the Secretary has failed to do so.

Now, in his first case on the question of valuation of closely-held employer stock sold to an ESOP, the Secretary shows that he can identify certain standards. He argued in the district court that where an appraisal was used, the fiduciaries must investigate any changed circumstances. Specifically, he argued that adoption and implementation of an ESOP after the appraisal had a negative effect on the stock value; that MCS' statutory obligation to guarantee the payment of its ESOP's bank loan made in a leveraged purchase of MCS stock had a negative effect on value; and that the delay in achieving projected revenues had a negative effect on value even if later projections just preceding the stock sales were greater and realistic. The Secretary further argued that even if the Rotan Mosle appraisal was correct at the time of the sales, the appraisal was of 100% of the stock, and the price for the stock sold to the ESOP should have been reduced from the per share value for 100% because the stock was a minority block and was not marketable.

If these theories of the Secretary have any validity, why weren't they tested in the public forum required for implementing them as regulations? It is inherently unfair for the Secretary to be able to challenge conduct on the basis of rules made up after the transaction he challenges is completed. In this case, neither the district court nor the court of appeals was willing to embrace the Secretary's arguments for traditional valuation discounts under Revenue Ruling 59-60. Yet that was one of the Secre-

tary's major theses to support his contention that more was paid for the stock than its alleged true value. If this thesis had been tested and similarly found wanting in the public process of writing regulations, this expensive and protracted litigation, including the related class action suit in Alabama, might have been avoided.

The decision below gives the Secretary no incentive to promulgate regulations on this subject. The Secretary is unlikely to do so now when he is in a position to use the prudent man rule to challenge the valuations made by honest ESOP fiduciaries in good faith, especially since the burden is on the ESOP fiduciaries claiming an exemption to prove prudence in addition to "adequate consideration".

The decision below, if left standing, will encourage litigation as each transaction is tested on a case by case basis. The resulting uncertainty will not only be unfair to ESOP fiduciaries, and discourage persons from serving as such, but would also discourage the establishment of ESOPs, thereby frustrating Congress' intent to encourage the use of ESOPs to strengthen the free enterprise system in this country.[21]

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21. If the decision below is left to stand, the Secretary will have succeeded in persuading the courts to take over his lawful duty to promulgate regulations.

D. The undisturbed finding of the district court concerning the value of the stock at the time of the two transactions requires entry of judgment for petitioners on the alleged Section 406 violation.

The district court found that the "appraisal remained a reasonable approximation of the value of the stock transferred to the ESOP in August of 1976 and February of 1977."[22] The court of appeals did not hold this finding to be clearly erroneous. Rather, the court of appeals held that:

> "A court reviewing the adequacy of consideration under Section 3(18) is to ask if the price paid is 'the fair market value of the asset *as determined in good faith by the . . . fiduciary*;' it is not to redetermine the appropriate amount for itself *de novo*."[23]

Whether or not the court of appeals is correct is immaterial. The case was tried and defended on the issue of what the true value of the stock was at the time of the sales. The district court made a specific finding on value that was left undisturbed. That finding *necessarily* requires a conclusion that adequate consideration was paid. It is unjust to deny petitioners the "adequate consideration" exemption where the district court's finding that the appraisal remained a reasonable approximation of the value of the stock purchased remains undisturbed.

The district court's finding ought to be conclusive on the issue of payment of no more than "adequate considera-

22. District Court op., 541 F. Supp. 276, 287 (App. D, p. 66a).

23. Court of Appeals op., 716 F.2d 1455, 1467 (App. A, p. 23a), (emphasis added by court of appeals).

tion" and entitlement to the exemption under Section 408. Only where fair market value is less than the price paid should the issue of a good faith determination come into play.[24]

E. Where there was substantial evidence to support the district court's conclusion of prudence, and because the Secretary had the burden of proving imprudence, and because there is no evidence to support the court of appeals' conclusion of imprudence other than testimony discredited by the district court as biased, petitioners are entitled to judgment on the alleged section 404 violation.

None of the testimony of the Secretary's expert can be used to set aside the district court's finding on value as clearly erroneous.[25] Indeed, the finding was not set aside. Petitioners submit the testimony cannot be used by the court of appeals for any purpose. Yet it appears to have been used by the court below in its conclusion that the fiduciaries acted imprudently. The two imprudent acts found by the court below were the failure to investigate the impact on value of the delay in achieving pro-

24. See the position once taken by the IRS in a Technical Advice Memorandum issued March 23, 1982, published August 2, 1982 while the appeal of this case was pending before the court of appeals, and withdrawn for purposes of being reconsidered on September 30, 1982. IRS National Office Technical Advice Memorandum, Ref. No. 8231002, 9 Pens. Rep. (BNA) 1153 (August 2, 1982). (App. G, pp. 86a-91a).

25. *United States v. Mass. Bonding and Ins. Co.*, 303 F.2d 823, 827 (2nd Cir. 1962) ["The fact remains that the (district court) rejected their testimony on the ground he did not believe it and no phase of the testimony thus rejected can be considered by us as a basis for setting aside a finding as clearly erroneous"].

jected revenues and the same failure with respect to the establishment of the ESOP.

The only evidence offered by the Secretary that these events had a negative impact on the value of the stock was through expert testimony discredited as biased. The court of appeals is not permitted to *assume* a negative impact of these events on the stock's value to reach a finding contrary to the district court's finding on value without setting that finding aside as clearly erroneous.

The court of appeals is bound by the district court's finding of fact unless under the record as a whole, it is found to be "clearly erroneous" within the meaning of Rule 52 F.R.C.P.[26]

Since the district court's finding on value is undisturbed, and the testimony of the Secretary's expert cannot be used, there can be no basis in the record for finding negative value implications in the events the court of appeals feels petitioners did not adequately investigate. If there were no evidence of negative value implications, it certainly cannot be said, where the Secretary has the burden of proof, that the petitioners were imprudent for failure to investigate the events questioned by the court below.

F. Even if this court decides not to grant certiorari on the preceding five arguments, on equitable grounds it should review and reject the court of appeals' decision to remand this case for award of relief to the Secretary.

The result of this litigation will have no effect on the private interests of the individual beneficiaries and par-

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26. *McAllister v. United States*, 348 U.S. 19 (1954).

ticipants in the MCS ESOP. Their monetary interests have been settled in a class action suit in Alabama.[27] Following that settlement, the MCS ESOP was dissolved. No defendant in the suit below is or has been, since shortly after the settlement, a fiduciary of any ESOP. The Secretary at this stage is limited to a determination of the legality of specific conduct, and if appropriate, obtaining relief to vindicate the public interest it seeks to protect.[28]

This is an equitable proceeding, and the Secretary should not be entitled to equitable relief where his failure in his public duty of publishing regulations has contributed to the lack of guidance in this area, and to these petitioners' dilemma of being second-guessed with valuation theories formulated after the fact by the Secretary. The most fundamental principles of equity require denying relief to the Secretary for ignoring Congressional intent, and for resorting instead to cumbersome, expensive litigation to fashion principles of fiduciary law in this area.

CONCLUSION

The decision below is erroneous and is contrary to the intent of Congress. It raises questions of vital importance under ERISA concerning the valuation of stock of closely-held companies in the ESOP context, and the proper placing of the burden of proof in the context of an allegation of breach of prudency requirements under ERISA. Be-

27. *Adcock v. Pioneer Contract Services, Inc.*, No. CV 80-L-5274-NE (N.D. Ala. July 30, 1982) (unpublished final order).

28. See the discussion under "Reviewability" in the Court of Appeals op., 716 F.2d 1455, 1460-1463 (App. A, pp. 7a-13a).

cause this is a case of first impression, and will have a significant negative impact in the establishment of ESOPs by closely-held companies if not set aside, review by this court is appropriate. For the reasons which have been set forth, certiorari should be granted.

Respectfully submitted,

C. LELAND HAMEL *
2300 Citicorp Center
Houston, Texas 77002
(713) 658-8888

MORTON L. SUSMAN **
2400 Republic Bank Center
Houston, Texas 77002
(713) 222-1621

* Counsel of Record for Petitioners Esparza and Fritcher.

** Counsel of Record for Petitioners Robertson, Hairell, and Cunningham.

March 1, 1984

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Petition for Writ of Certiorari was served on the Secretary of Labor, plaintiff-respondent, by mailing a copy of same by first class United States mail in a properly addressed, postage pre-paid envelope on this the 1st day of March, 1984 to the following: Paula Page, Esq., U. S. Department of Labor, P. O. Box 1914, Washington, D. C. 20013.

C. LELAND HAMEL

APPENDIX

APPENDIX A

Raymond J. DONOVAN, Secretary of the
United States Department of Labor,
Plaintiff-Appellant Cross-Appellee,

v.

Kenneth R. CUNNINGHAM,
Defendant-Third Party Plaintiff-Appellee-Cross-Appellant,

L. J. Carter and Mark W. Perrin,
Defendants-Third Party Plaintiffs-Appellees-
Cross-Appellants-Cross-Appellees,

Salvador Esparza and Edward F. Fritcher,
Defendants-Third Party Plaintiffs-
Appellees-Cross-Appellants,

v.

Wilford H. HAIRELL and A. Mitchell Robertson,
Defendants-Third Party Plaintiffs-Appellees-
Cross-Appellants-Cross-Appellees,

v.

ALLIED BANK OF TEXAS,
Third Party Defendant-Cross-Appellee-Cross-Appellant,

v.

METROPOLITAN CONTRACT SERVICES, INC.,
Third Party Defendant-Cross-Appellee.

No. 82-2296.

United States Court of Appeals,
Fifth Circuit.

Oct. 17, 1983.

Secretary of Department of Labor brought action against members of administrative committee of employee stock ownership plan under various provisions

of Employee Retirement Income Security Act, alleging violation of fiduciary responsibilities. The United States District Court for the Southern District of Texas, John V. Singleton, Jr., Chief Judge, 541 F.Supp. 276, entered judgment for the defendants, and Secretary appealed. The Court of Appeals, Gee, Circuit Judge, held that: (1) case was not mooted by settlement action entered into in separate action between individual plaintiffs and defendants; (2) doctrines of res judicata and collateral estoppel did not bar Secretary from relitigating issues raised in private suit; (3) administrative committee members' failure to conduct investigations sufficient to determine if independent appraisal remained reasonable approximation of fair market value at time appraisal was relied upon breached their fiduciary duties under Act; (4) whether succeeding members of administrative committee had knowledge of predecessors' breach of fiduciary duties was question for district court to resolve on remand; and (5) trial court's award of attorney fees to third-party defendants was not abuse of discretion.

Affirmed in part, reversed in part, vacated in part, and remanded.

* * *

Before THORNBERRY, GEE and WILLIAMS, Circuit Judges.

GEE, Circuit Judge:

The Secretary of Labor brought this lawsuit against various fiduciaries of a certain employee stock ownership plan ("ESOP") established under the Employee Retirement Income Security Act of 1974 ("ERISA").[1] The

1. Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of U.S.C.) (1974).

Secretary's principal claim is that these defendants breached their duties as fiduciaries under ERISA by purchasing certain stock on behalf of the ESOP for more than adequate consideration. The suit was tried without a jury and the district court entered judgment for the defendants. The Secretary has appealed.

[1] An ESOP is a form of employee benefit plan designed to invest primarily in securities issued by its sponsoring company. 29 U.S.C. § 1107(d)(6) (1976). The ESOP concept is the brainchild of Louis O. Kelso, who has advanced it as a device for expanding the national capital base among employees—an effective merger of the roles of capitalist and worker.[2] Congress has enacted a number of laws designed to encourage employers to set up such plans. *See* note 23, *infra*.

As is true of all employee benefit plans covered by ERISA, ESOPs are subject to an impressive and somewhat bewildering array of rules and regulations governing their substance and administration, as well as their eligibility for favorable tax treatment. *See generally* L. Brown, *ERISA Source Manual* (1982-1983). For present purposes, an understanding of these details is unnecessary; a thumbnail sketch of basic ESOP mechanics will suffice. An employer desiring to set up an ESOP will execute a written document to define the terms of the plan and the rights of beneficiaries under it. 29 U.S.C. § 1102(a)

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2. *See* L. Kelso & P. Hetter, *Two Factor Theory: The Economics of Reality* (1967); L. Kelso & M. Adler, *The Capitalist Manifesto* (1958); *but see* Carlson, *ESOP and Universal Capitalism*, 31 Tax. L. Rev. 289 (1976) (questioning some of the social benefits claimed for ESOPs). Others have recommended the ESOP as a device for achieving a variety of objectives for its corporate sponsor, such as financing of acquisitions or divestitures, or for the sponsor's major shareholders as an estate and planning tool. *See generally Employee Stock Ownership Plans* 109-40 (J. Bachelder ed. 1979).

(1976). The plan document must provide for one or more named fiduciaries "to control and manage the operation and administration of the plan." *Id.*, § 1102(a)(1). A trust will be established to hold the assets of the ESOP. *Id.*, § 1103(a). The employer may then make tax-deductible contributions to the plan in the form of its own stock or cash. If cash is contributed, the ESOP then purchases stock in the sponsoring company, either from the company itself or from existing shareholders. Unlike other ERISA-covered plans, an ESOP may also borrow in order to invest in the employer's stock. In that event, the employer's cash contributions to the ESOP would be used to retire the debt. With this overview in mind, we can now turn to the facts relevant to the Secretary's appeal.

Facts

Metropolitan Contract Services, Inc. ("MCS") is a contract trucking firm engaged in the business of making bulk deliveries for retail stores in several states. On December 15, 1975, the MCS board of directors voted to establish an ESOP (the "Metropolitan ESOP"), effective July 1, 1975, for the employees of MCS. The plan document provided that decisions regarding plan administration and investments were to be made by named fiduciaries composing a five-member administrative committee to be appointed by the MCS board of directors. In August 1976, the members of the MCS board of directors appointed themselves as the administrative committee of the ESOP, and at all times relevant to this case the current MCS directors served simultaneously as administrative committee members. As required by ERISA, a trust was established to maintain custody of ESOP assets. At all relevant times, Allied Bank of Texas ("Allied Bank") served as trustee.

During the time period when the Metropolitan ESOP was established and the transactions challenged by the Secretary took place, the board and administrative committee consisted of appellees Cunningham, Fritcher, Hairell, Robertson and Esparza. Mr. Cunningham was chairman of the board, chief executive officer and sole shareholder of MCS. Mr. Fritcher was secretary-treasurer and comptroller of MCS; defendants Hairell and Robertson were vice-presidents. Mr. Esparza was president of Metro Contract Services, Inc., another company wholly owned by Mr. Cunningham.

In 1977, after the challenged transactions had taken place, appellees Fritcher and Esparza were replaced on the board and administrative committee by appellees Perrin and Carter. Mr. Perrin, who had been outside counsel to MCS since before the ESOP was established, had become president of the company in mid-1977. Mr. Carter replaced Mr. Fritcher as comptroller.

The Secretary alleges that the appellees breached their fiduciary duties to the ESOP in connection with two transactions whereby the ESOP acquired MCS stock from Mr. Cunningham (the "ESOP transactions"). The first transaction occurred in August 1976. The defendants who were then members of the MCS board of directors[3] voted in that capacity to contribute $288,000 in cash to the ESOP for the purpose of acquiring stock from Cunningham. Then, in their capacity as members of the administrative committee, the same appellees voted to purchase 1440 shares of MCS stock from Cunningham at $200 per share for a total of $288,000. As a result of this transaction, the ESOP owned approximately 14% of the

3. Cunningham, Fritcher, Hairell, Robertson and Esparza.

10,100 outstanding MCS shares; Cunningham retained the remaining 86%.

The second challenged transaction occurred in February 1977. The same appellees, in their dual capacities as directors and administrative committee members, purchased on behalf of the ESOP an additional 5000 shares of MCS stock from Cunningham at $200 per share, for a total price of $1 million. To fund this second purchase, the administrative committee caused the ESOP to borrow $1 million from Allied Bank of Texas. Pursuant to the plan document and the loan agreement, MCS was obligated to make sufficient yearly ESOP contributions to amortize this loan. After this second transaction, the ESOP owned 34% of the outstanding MCS stock, and Cunningham held the balance of 66%.[4]

In his complaint, the Secretary alleged that the defendants who were members of the administrative committee at the time of the two ESOP transactions breached various duties imposed upon them by ERISA by "failing to follow the procedures necessary to determine the fair market value of the shares" and by "causing the Plan to pay defendant Cunningham more than adequate consideration" for his stock. Cunningham was alleged to have violated certain rules against self-dealing. The Secretary also alleged that the successor fiduciaries Perrin and Carter are liable as co-fiduciaries under ERISA for

4. Shortly before the second sale of stock to the ESOP, another transaction substantially increased the outstanding shares of MCS. In January 1977, Cunningham had exchanged all the stock in his wholly-owned company, Metro Contract Services, Inc., ("Metro") for 9,000 shares of MCS stock. Thereafter, Metro was operated as a wholly-owned subsidiary of MCS, and MCS had 19,100 shares outstanding. Following the second ESOP transaction, Cunningham held 12,660 MCS shares and the ESOP held 6,440.

concealing or failing to remedy the misconduct of the other committee members. He sought to enjoin the defendants from violating ERISA and from serving as fiduciaries under ERISA for five years. He also asked the court to order defendants to "restore the Plan to its rightful economic place," and for other appropriate equitable relief.

We will first address the appellees' claims that for various reasons the district court's judgment in their favor is no longer reviewable. Because we conclude that such is not the case, we will review the merits by first examining the relevant provisions of ERISA and will then seek to measure the defendants' conduct by the yardstick set up by the statute.

Reviewability

The appellees argue that the Secretary's appeal must be dismissed because of the preclusive effect of a settlement entered in a related lawsuit. They argue that the settlement renders this appeal moot, or alternatively that it bars our consideration of the issues presented by way of *res judicata* or collateral estoppel. We are not persuaded.

The Secretary filed the present action in January of 1980. In October of 1980, a number of private plaintiffs, some of whom were beneficiaries of the Metropolitan ESOP,[5] filed a class action in Alabama federal district court (the "Alabama lawsuit") against the same persons who are defendants in the present case. The plaintiffs in the Alabama lawsuit complained of the same transactions

5. The plaintiff class was eventually redefined to include all participants in the Metropolitan ESOP.

at issue in the present case, contending, as does the Secretary, that the defendants breached their duties under ERISA.[6]

The present case proceeded to judgment and this appeal was filed. The defendants then offered to settle the Alabama lawsuit. Relying in part upon the district court's decision in this case, the Alabama district court approved and entered a comprehensive settlement agreement that purports to bind all participants in the Metropolitan ESOP and all defendants in that case. *Adcock v. Pioneer Contract Services, Inc.*, No. CV80-L-5274-NE (N.D. Ala. July 30, 1982) (unpublished final order). The agreement provides that all issues of the defendants' performance of their fiduciary duties are settled, that Cunningham's sales to the Metropolitan ESOP were made for "adequate consideration," and that the ESOP is to be dissolved. Under the agreement, MCS and its insurers (not the individual defendants) became obligated to pay sums totalling $82 per share of MCS stock owned by the ESOP into a court-administered trust fund.[7] The trustee will distribute cash pro rata to the former ESOP participants. The MCS stock held by the ESOP will be returned to MCS by the trustee. Finally, the agreement provides that "inasmuch as it is the intention of the parties to settle all issues, including those relating to the value

6. The Alabama lawsuit also comprised claims relating to other ESOPs and other transactions. Due to the presence of additional parties and issues in the Alabama lawsuit, the Judicial Panel on Multi-District Litigation denied the defendants' motion to consolidate that case with the present one.

7. The attorney for the plaintiffs in the Alabama lawsuit is to serve as trustee. The agreement also provided for payment by MCS and its insurers of attorneys' fees and costs incurred by the plaintiffs in the Alabama lawsuit.

of the stock sold to . . . the Metropolitan ESOP," any payments related to the price of that stock made "as a result of any private litigation or any action by the United States, shall be returned by the Trustee to the person making such payment."

Mootness. The appellees argue that this settlement agreement renders the present appeal moot because this court is now unable to award any relief of "practical significance." It is certainly true that "if, pending an appeal an event occurs which renders it impossible for [an] appellate court to grant any relief or renders the decision unnecessary, the appeal will be dismissed as moot." *Thibaut v. Ourso,* 705 F.2d 118, 121 (5th Cir. 1983) (quoting *NLRB v. O.E. Szekely & Assoc., Inc.,* 259 F.2d 652, 654 (5th Cir. 1958)) (emphasis deleted). Obviously, the granting by another court of the relief sought would constitute such an event: *See Washington Market Co. v. District of Columbia,* 137 U.S. 62, 11 S.Ct. 4, 34 L.Ed. 572 (1890); 13 C. Wright, A. Miller, & E. Cooper, Federal Practice & Procedure § 3533 at 276 & n. 60 (1975 & Supp. 1980). However, the settlement agreement did not render all relief sought by the Secretary either unnecessary or impossible to achieve; his claims for injunctive relief are not moot.[8]

The appellees argue that because the Metropolitan ESOP has been dissolved, and because none of the appellees is currently a fiduciary under a plan covered by ERISA and none of them intends to serve in such a capacity, any injunctive relief secured by the Secretary would be of no practical, "real-world" significance. We

8. The Secretary's claims for other equitable relief are discussed at note 10, *infra.*

do not agree. The injunctive relief sought by the Secretary is not limited to actions affecting the Metropolitan ESOP. He asks that if violations of ERISA are found, the appellees be enjoined from violating the statute in the future and, more specifically, that they be enjoined from serving as fiduciaries under *any* ERISA plan for a five-year period.

[2-4] It is well-settled that, in a suit for injunctive relief, the voluntary cessation of allegedly illegal conduct does not moot the controversy arising from the challenged activity. *See, e.g., Allee v. Medrano,* 416 U.S. 802, 94 S.Ct. 2191, 40 L.Ed.2d 566 (1974); *United States v. Concentrated Phosphate Export Ass'n.,* 393 U.S. 199, 89 S.Ct. 361, 21 L.Ed.2d 344 (1968); *United States v. Realty Multi-List, Inc.,* 629 F.2d 1351, 1387-88 (5th Cir. 1980). This is because "[t]he defendant is free to return to his old ways." *United States v. W.T. Grant Co.,* 345 U.S. 629, 632, 73 S.Ct. 894, 897, 97 L.Ed. 1303 (1953). To obtain a dismissal on mootness grounds, a defendant bears a heavy burden to show that "there is no reasonable expectation that the wrong will be repeated." *Id.* at 633, 73 S.Ct. at 897. The appellees have not done so here. Their bare assurances that they do not intend to serve as ERISA fiduciaries in the future are clearly insufficient to meet their burden of persuasion. *Id.; United States v. Concentrated Phosphate Export Ass'n.,* 393 U.S. at 203, 89 S.Ct. at 364. This is particularly true in the face of appellees' continuing insistence that their discontinued activities were legal and their continued occupation of positions that would enable resumption of ESOP activities. *See Walling v. Helmerich & Payne, Inc.,* 323 U.S. 37, 43, 65 S.Ct. 11, 14, 89 L.Ed. 29 (1944); *Meltzer v. Board of Public Instruction of Orange County,*

548 F.2d 559, 571-73 (5th Cir. 1977) *modified*, 577 F.2d 311 (5th Cir. 1978) (en banc), *cert. denied*, 439 U.S. 1089, 99 S.Ct. 872, 59 L.Ed.2d 56 (1979); 13 C. Wright et al, *supra*, at 282. The potential for recurrence established by these facts, coupled with the public interest in having the legality of the challenged practices settled,[9] leads us to conclude that a live controversy is presented and accordingly that this case is not moot.

Res Judicata and Collateral Estoppel. The appellees also contend that the Alabama settlement agreement is *res judicata* of the present action or, alternatively, that the Secretary is at least precluded from relitigating certain issues resolved by the settlement. This argument misapprehends the nature of the Secretary's lawsuit.

Our court has recently described "the general principle of law that the United States will not be barred from independent litigation by the failure of a private plaintiff." *United States v. East Baton Rouge Parish School Board*, 594 F.2d 56, 58 (5th Cir. 1979) (collecting cases); 18 C. Wright, *et al, supra*, § 4458 at 520.

> This principle is based primarily upon the recognition that the United States has an interest in enforcing federal law that is independent of any claims of private citizens. . . . Also, any contrary rule would impose an onerous and extensive burden upon the United States to monitor private litigation in order to ensure that possible mishandling of a claim by a private plaintiff could be corrected by intervention.

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9. *See United States v. W.T. Grant, Inc.*, 345 U.S. at 632, 73 S.Ct. at 897; *Alton & So. Ry. v. International Ass'n. of Machinists & Aerospace Workers*, 463 F.2d 872, 880 (D.C. Cir. 1972) ("When the court views the public interest as greater a lesser possibility of repetition may suffice [to preclude a finding of mootness]."); 13 C. Wright *et al, supra*, at 267-68.

East Baton Rouge Parish, 594 F.2d at 58 (footnote omitted).

The cases that have developed this principle have often involved statutory schemes like ERISA that provide for private enforcement of individual rights as well as suits by the government to vindicate the public interest in compliance with the law. For example, in suits to enforce Section 5 of the Voting Rights Act, the Attorney General of the United States is not bound by the results of prior litigation of the same issues by private parties. *Hathorn v. Lovorn*, 457 U.S. 255, 268 n. 23, 102 S.Ct. 2421, 2430 n. 23, 72 L.Ed.2d 824 (1982); *City of Richmond v. United States*, 422 U.S. 358, 373 n. 6, 95 S.Ct. 2296, 2305 n. 6, 45 L.Ed.2d 245 (1975); *East Baton Rouge Parish, supra*. Similarly, the Equal Employment Opportunity Commission may bring discrimination charges against an employer even after its employees have settled their private claims. *New Orleans Steamship Ass'n. v. EEOC*, 680 F.2d 23, 25 (5th Cir. 1982); *EEOC v. Kimberly-Clark Corp.*, 511 F.2d 1352, 1361 (6th Cir.), *cert. denied*, 423 U.S. 994, 96 S.Ct. 420, 46 L.Ed.2d 368 (1975).

[5] As in those cases, the Secretary in the present case seeks to vindicate a public interest that is broader than the interests of the plaintiffs in the Alabama lawsuit. Those plaintiffs were interested in recouping only their *own* economic losses; the Secretary seeks to determine the legality of specific conduct and to prevent those who have engaged in illegal activity from causing loss to *any* future ERISA plan participant. Thus, although the monetary settlement sought in the prior litigation may have achieved the goals of the private plaintiffs, it is clearly inadequate to vindicate the broader interest of the govern-

ment.[10] Accordingly, the plaintiffs in the Alabama lawsuit were not proper representatives of the government interest and the Secretary is not precluded from relitigating here the issues raised in that case.[11]

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10. A number of courts have suggested that a prior private settlement may limit the scope of the relief that the government may seek on behalf of the settling parties. *EEOC v. Kimberly-Clark Corp.*, 511 F.2d at 1361. *See also New Orleans Steamship*, 680 F.2d at 25; *Truvillion v. King's Daughters Hospital*, 614 F.2d 520, 525 (5th Cir. 1980) (stating, in dicta, that "the E.E.O.C. may not bring a second suit based on the transactions that were the subject of a prior suit by a private plaintiff, unless the E.E.O.C. seeks relief different from that sought by the individual."); *EEOC v. Huttig Sash & Door Co.*, 511 F.2d 453, 456 (5th Cir. 1975) (dicta). The appellees thus argue that any claims for monetary relief by the Secretary on behalf of the ESOP participants are barred by res judicata. The Secretary responds that because the equitable remedies of disgorgement or constructive trust are intended to prevent unjust enrichment, *see* V A. Scott, *Trusts*, § 462.2 (3d ed. 1967), they are available to the government, even if any payments to the ESOP participants would be barred. *Cf.* VI L. Loss, *Securities Regulation* 3574 (2d ed. Supp. 1969) (suggesting that those who reap illicit profits by trading on inside information may be required to disgorge them to the government when injured purchasers or sellers cannot be traced).

Because the district court found for the defendants, these arguments were not considered below. In their briefs to us, the parties have not adequately addressed the issues raised by these remedial arguments in the special context of ERISA. Since all the substantive issues in this case are raised by the Secretary's claims for injunctive relief, and since our holding will necessitate a remand anyway, we think the best approach is for the district court to first consider the disgorgement claims when it determines the scope of relief on remand.

11. Contrary to appellees' suggestion, *Montana v. United States*, 440 U.S. 147, 99 S.Ct. 970, 59 L.Ed.2d 210 (1979), has no application here. In *Montana*, the United States had caused private parties to initiate a lawsuit and had effectively controlled the litigation throughout. *Id.* at 155, 99 S.Ct. at 974. The Supreme Court held that in those circumstances, the United States would be collaterally estopped to relitigate issues decided in the private suit. Although the record in the present case indicates that the Secretary consulted and cooperated with counsel for the Alabama plaintiffs to a limited extent, the government did not have a "sufficient 'laboring oar' in the conduct of the [Alabama] litigation to actuate principles of estoppel." *Id.*

Duties of ESOP Fiduciaries under ERISA

The parties agree that in their capacities as members of the Metropolitan ESOP administrative committee, the appellees were fiduciaries as that term is defined in ERISA.[12] Establishment of standards of fiduicary responsibility in the pension plan context was one of the primary objectives of ERISA.[13] Accordingly, the statute includes a comprehensive scheme of both general and specific provisions regulating the conduct of fiduciaries. The Secretary has charged the appellees with violating the general fiduciary responsibility standards of ERISA Section 404 as well as the specific prohibited transaction rules of Section 406 in consummating the two ESOP transactions.

The general duties of fiduciaries are set out in Section 404 of ERISA:

> [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
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> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
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> (ii) defraying reasonable expenses of administering the plan;

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12. 29 U.S.C. § 1002(21)(A) (1976).

13. Congress expressed this policy in the statute itself:

> It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.

29 U.S.C. § 1001(b) (1976).

> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> * * *
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

29 U.S.C. § 1104(a) (1976).[14]

[6] As we have observed before, Section 404 imposes upon fiduciaries a duty of loyalty and a duty of care. *Iron Workers Local No. 272 v. Bowen*, 624 F.2d 1255, 1260 (5th Cir. 1980). The legislative history of ERISA indicates that Congress intended to incorporate in Section 404 the "core principles of fiduciary conduct" that were developed in the common law of trusts, but with modifications appropriate for employee benefit plans.[15] Also, Congress has exhorted those who must interpret and apply ERISA's fiduciary standards to do so "bearing in mind

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14. Section 404 also includes a general requirement diversification of plan assets, 29 U.S.C. § 1104(a)(1)(C) (1976), but provides that the requirement is not violated by an investment in employer securities by an ESOP. *Id.* §§ 1104(a)(2), 1107(d)(5) & (6).

15. S. Rep. No. 127, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. Code Cong. & Ad. News 4838, 4866; H.R. Rep. No. 533, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. Code Cong. & Ad. News 4639, 4649-51; H.R. Rep. No. 1280, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. Code Cong. & Ad. News 5038, 5076. ERISA's modifications of existing trust law include imposition of duties upon a broader class of fiduciaries, 29 U.S.C. § 1002(21) (1976), prohibition of exculpatory clauses, *id.* § 1110(a), broad disclosure and reporting requirements, *id.* §§ 1021-31, and nationwide uniformity of rules. *See generally* H.R. Rep. No. 533, *supra*, 1974 U.S. Code Cong. & Ad. News at 4649-51.

the special nature and purpose of employee benefit plans." H.R. Rep. No. 1280, *supra*, 1974 U.S. Code Cong. & Ad. News at 5083. *See Marshall v. Glass/Metal Ass'n. & Glaziers & Glassworkers Pension Plan*, 507 F.Supp. 378, 383 (D. Ha. 1980). ("[Section 1104] establish[es] uniform federal requirements to be interpreted both in the light of the common law of trusts, as well as with a view toward the special nature, purpose, and importance of modern employee benefit plans.").

[7, 8] As a supplement to the general duties imposed on fiduciaries by Section 404, ERISA also incorporates a detailed list of specifically prohibited transactions.[16] These

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16. Section 406, 29 U.S.C. § 1106 (1976), is the principal prohibited transaction section:

(a) Except as provided in section 1108 of this title:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extention of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 1107 (a) of this title.

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 1107(a) of this title.

(b) A fiduciary with respect to a plan shall not—

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

prohibited transaction rules are an important part of Congress's effort to tailor traditional judge-made trust law to fit the activities of fiduciaries functioning in the special context of employee benefit plans. The object of Section 406 was to make illegal per se the types of transactions that experience had shown to entail a high potential for abuse. *Cutaiar v. Marshall*, 590 F.2d 523, 529 (3d Cir. 1979); *Marshall v. Kelly*, 465 F.Supp. 341, 354 (W.D. Okl. 1978); *see also Iron Workers v. Bowen*, 624 F.2d at 1261. In the complex setting of employee benefit plans, brightline rules are advantageous to beneficiaries and fiduciaries alike, providing assured protection to the former and clear notice of responsibility to the latter.

Unfortunately, the present case is not easily solved by application of bright-line rules. In addition to violations of Section 404, the Secretary has charged the MCS fiduciaries with violating Section 406 by causing the ESOP to enter into a transaction with and transfer its assets to, a "party in interest."[17] The Secretary also alleged that

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(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

(c) A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year period ending on the date of the transfer.

Section 407, 29 U.S.C. § 1107 (1976), limits the amount of employer-issued securities that may be held by most plans, but specifically exempts ESOPs from its limitations. *Id.* §§ 1107(b)(1), (d)(3)(A) & (6).

17. 29 U.S.C. §§ 1106(a)(1)(A) & (D) (1976). ERISA defines "party in interest' to include any fiduciary, employer of employees covered by the plan, or officer or director of such employer. 29 U.S.C. § 1002(14) (1976). The district court correctly found that Cunningham was a party in interest with respect to the Metropolitan ESOP.

Cunningham violated Section 406 by dealing with plan assets in his own interest or on behalf of someone with an interest adverse to the plan.[18]

[9] These per se rules are not automatically applicable to ESOP fiduciaries, however. Doubtlessly recognizing that such absolute prohibitions would significantly hamper the implementation of ESOPs, particularly by small companies, Congress enacted in Section 408 a conditional exemption from the prohibited transaction rules for acquisition of employer securities by ESOPs and certain other plans. 29 U.S.C. § 1108(e) (1976). An ESOP may acquire employer securities in circumstances that would otherwise violate Section 406 if the purchase is made for "adequate consideration." *Id.*[19]

The crux of the Secretary's case is his claim that the appellees purchased MCS stock from Cunningham for more than adequate consideration. Obviously, the Section 406 violations can be established only if the "adequate consideration" exemption from Section 406 is not applicable. Similarly, the Secretary's claim that the appellees' conduct violated their general duties of loyalty and prudence under Section 404 is based on his view that they paid too much for the stock. He does not contend that the stock purchases were not undertaken "solely in the interest of the participants" of the ESOP for any other reason,[20] nor does he contend that the purchase of MCS

18. 29 U.S.C. § 1106(b) (1976).

19. The statute also requires that no commission be charged with respect to the transaction. 29 U.S.C. § 1108(e)(2) (1976). No issue has been raised regarding a commission in the present case.

20. Accordingly, we need not address the issue whether in some circumstances fiduciaries may violate the "sole benefit" rule by entering into a transaction for adequate consideration that benefits parties

stock, if made for adequate consideration, would have been imprudent for some other reason. Thus, although payment of adequate consideration is a statutory defense only to a violation of Section 406, and not of Section 404, under the Secretary's theory of this particular case, our inquiry will be the same.[21]

In Section 3(18) ERISA provides that "in the case of an asset other than a security for which there is a generally recognized market," the term "adequate consideration" means *"the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary [of Labor]."* 29 U.S.C. § 1002(18) (1976) (emphasis added). Predictably, the parties espouse sharply differing views of the meaning of this language. The appellees contend that their subjective

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other than the plan participants. *Compare Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982) *and* 19 *Business Organizations*, S. Young, *Pension and Profit Sharing Plans* § 6.15[5][b] at 6-122 ("[A]n ESOP's acquisition of employer stock from the employer corporation, or from an existing shareholder, would satisfy the exclusive benefit requirement of ERISA . . . , so long as the investment is one that is prudent for an ESOP fiduciary and the purchase price does not exceed fair market value."), *with* Note, *The Duties of Employee Benefit Plan Trustees Under ERISA in Hostile Tender Offers*, 82 Colum. L. Rev. 1692, 1715-19 (1982) (suggesting that incidental benefits accruing to non-participants may violate section 404).

21. All other alleged violations but one are based on adequacy of consideration. The Secretary alleged that the fiduciaries violated section 404 by failing to follow the plan document requirement to purchase stock for fair market value. He alleged that Carter and Perrin knew of the violations by the other fiduciaries and either concealed them or failed to act to remedy them in violation of Section 405. 29 U.S.C. § 1105 (1976).

The only allegation not dependent on the adequacy of the stock price is that Cunningham violated the terms of the plan document (and consequently Section 404) by participating in the decision to buy his stock. That issue is discussed below.

good faith in setting a purchase price is all that the statute requires. The Secretary has pitched his tent at the opposite pole: notwithstanding his failure during the eight years of ERISA to promulgate regulations as the statute contemplates, he urges us to require ESOP fiduciaries to follow a set of highly specific estate and gift tax regulations promulgated by the Internal Revenue Service to guide valuation of closely-held stock for tax purposes. We reject both approaches.

It is not surprising that the legislative history of ERISA contains no more than passing reference to the adequate consideration provision; the statute itself makes clear that Congress intended for the Secretary to flesh out the standards for fiduciaries to follow in establishing that figure.[22] As noted, he has not done so. Moreover, until the present case, no court has had occasion to interpret or apply Section 3(18). It is with some trepidation that we undertake to be the first to do so, unaided by the views of others, for we must satisfy the demands of Congressional policies that seems destined to collide. On the one hand, Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment,[23] and has warned against

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22. It should not be necessary to point out that the appropriate means of implementing that legislative intent is by way of an orderly regulatory proceeding. 29 U.S.C. § 1135 (1976), not by attempting to convince a court to short-circuit the process.

23. *See, e.g.*, Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981); Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976); Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975); Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1974); ERISA, *supra*. For an in-depth description of the manner in which these and other pieces of legislation have encouraged ESOP formation, *see* J. Bachelder & R. Rizzo, *ESOPs, TRASOPs, PAYSOPs and Other Employee Stock*

judicial and administrative action that would thwart that goal.[24] Competing with Congress' expressed policy to foster the formation of ESOPs is the policy expressed in equally forceful terms in ERISA: that of safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility. *See* note 13, *supra.*

Our task in interpreting the statute is to balance these concerns so that competent fiduciaries will not be afraid to serve, but without giving unscrupulous ones a license to steal. More, though we are guided by principles of trust law, we must bear in mind that in ERISA Congress departed from the absolute common law rule against fiduciaries' dual loyalties. ERISA clearly provides that a fiduciary may be an officer or employee of the company whose securities he purchases on behalf of a plan. 29 U.S.C. § 1108(c)(3); *see generally Donovan v. Bierwirth,* 538 F.Supp. 463, 468 (E.D.N.Y. 1981), *modified,* 680 F.2d 263 (2d Cir. 1982), *cert. denied,* ____U.S.____, 103 S.Ct. 488, 74 L.Ed.2d 631 (1983). Thus, the stringent prophylactic rules of the common law cannot be incorporated reflexively under the statute.

An examination of the structure of ERISA's fiduciary responsibliity provisions shows that Congress was aware

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Ownership Plans, 18-23 (1982); Hutchinson, *Employee Stock Ownership Plans: A New Tool in the Collective Bargaining Inventory?,* 26 Am. U. L. Rev. 536 (1977).

24. "The Congress is deeply concerned that the objectives sought by [the series of laws encouraging ESOPs] will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans." Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h), 90 Stat. 1590 (1976).

of, and has struck a balance between, the competing policies we have identified. Though freed by Section 408 from the prohibited transaction rules, ESOP fiduciaries remain subject to the general requirements of Section 404. *Eaves v. Penn*, 587 F.2d 453 (10th Cir. 1978); *cf. Donovan v. Bierwirth*, 680 F.2d at 271.[25] Their principal responsibility in selecting investments is to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B) (1976). Under ERISA, as well as at common law, courts have focused the inquiry under the "prudent man" rule on a review of the fiduciary's independent investigation of the merits of a particular investment, rather than on an evaluation of the merits alone. *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983); *Donovan v. Bierwirth*, 538 F.Supp. at 470, 680 F.2d at 273; *Marshall v. Glass/Metal Ass'n.*, 507 F.Supp. at 384; III A. Scott, *The Law of Trusts* § 227.1 at 1809-11 (3d ed. 1967); *Note, Fiduciary Standards and the Prudent Man Rule Under the Employment* [*sic*] *Retirement Income Security Act of 1974*, 88 Harv. L. Rev. 960, 965 (1975). As a leading commentator puts it, "the test of prudence—the Prudent Man Rule—is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed." 19B *Business Organizations*, S. Young, *Pension and Profit-Sharing Plans* § 17.02[3] at 17-29. In addition,

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25. Except those relating to diversification, 29 U.S.C. § 1104(a)(2) (1976).

the prudent man rule as codified in ERISA is a flexible standard: the adequacy of a fiduciary's investigation is to be evaluated in light of the "character and aims" of the particular type of plan he serves.[26]

[10] We think an understanding of these general fiduciary duty provisions sheds a great deal of light on the meaning of Section 3(18). ERISA's requirement that ESOP fiduciaries purchase employer stock for "adequate consideration" must be interpreted so as to give effect to the Section 404 duties to which those persons remain subject. In this regard, it is especially significant that the adequate consideration test, like the prudent man rule, is expressly focused upon the *conduct* of the fiduciaries. A court reviewing the adequacy of consideration under Section 3(18) is to ask if the price paid is "the fair market value of the asset *as determined in good faith by the . . . fiduciary;*" it is not to redetermine the appropriate amount for itself *de novo*. Contrary to the appellees' contentions, this is not a search for subjective good faith—a pure heart and an empty head are not enough. The statutory reference to good faith in Section 3(18) must

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26. 29 U.S.C. § 1104(a)(1)(B) (1976). Some commentators have suggested that the reference in Section 404 to a prudent man "familiar with such matters" creates a "prudent expert" standard under ERISA. *E.g.* Cummings, *Purposes and Scope of Fiduciary Provisions under the Employee Retirement Income Security Act of 1974*, 31 Bus. Law. 15, 35-36 (1975). However, a review of the relevant history of Section 404 does not support this view; rather, it confirms that the emphasis of Section 404 is on flexibility. *See* Klevan, *Fiduciary Responsibility Under ERISA's Prudent Man Rule: What are the Guideposts?*, 44 J. Tax. 152 (1976) (surveying history of ERISA and of the precursor of ERISA's fiduciary provisions, H.R. 16462); *see also* Hutchinson, *The Federal Prudent Man Rule Under ERISA*, 22 Vill. L. R. 15, 26-27, 42 (1976-77); Little & Thrailkill, *Fiduciaries Under ERISA: A Narrow Path to Tread*, 30 Vand. L. Rev. 1, 12-13 (1977). The level of knowledge required of a fiduciary will vary with the nature of the plan.

be read in light of the overriding duties of Section 404. Doing so, we hold that the ESOP fiduciaries will carry their burden to prove that adequate consideration was paid[27] by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing.[28]

Liability of the Principal Fiduciaries

In this section we consider whether the five fiduciaries who approved the ESOP transacitons fulfilled their duties.

The Secretary charged appellee Cunningham with violating Section 404 by failing to act in accordance with plan documents. 29 U.S.C. § 1104(a)(1)(D) (1976). The Metropolitan ESOP plan document provides that "[a]ny Committee member having any interest in a transaction being voted upon by the Committee shall not vote thereon nor participate in the decision." The Secretary alleged that Cunningham had participated in the administrative committee's decision and voted to buy MCS stock.

[11, 12] The district court expressly found that "Mr. Cunningham did not participate in the vote or decision concerning the purchase by the ESOP of the MCS stock."

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27. As the Supreme Court has observed in a different context, it seems "fair and reasonable" to place the burden of proof upon a party who seeks to bring his conduct within a statutory exception to a broad remedial scheme. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126, 73 S.Ct. 981, 985, 97 L.Ed. 1494 (1953). This is especially appropriate where, as here, the parties claim the exemption for conduct with respect to which they have an inherent, though statutorily permitted, conflict of interest. *Marshall v. Snyder*, 572 F.2d 894, 900 (2d Cir. 1978) (burden of proof is on ERISA fiduciary claiming a Section 408 exemption from self-dealing prohibition of Section 406).

28. As the district court put it, "good faith [entails] not only the sole motivation of benefiting the ESOP but also the application of sound business principles of evaluation." 541 F.Supp. at 284.

Donovan v. Cunningham, 541 F.Supp. 276, 287 (S.D. Tex. 1982). In finding that Mr. Cunningham did not vote, the court was required to resolve conflicting testimony. The Secretary does not seriously attack this finding and we do not consider it clearly erroneous. However, Mr. Cunningham's unrefuted testimony, in deposition and at trial, was that he did participate in the fiduciaries' decision to pay $200 per share for it. The district court's finding to the contrary is clearly erroneous and we conclude that Cunningham acted contrary to the terms of the plan document in violation of Section 404.

We come now to the heart of this case. The district court held that the fiduciaries who approved the ESOP transactions had taken steps to determine the fair market value of MCS stock that were "reasonable and prudent for individuals in the position of these members of the Administrative Committee of the MCS ESOP." 541 F. Supp. at 287. These steps consisted of reliance upon an independent appraisal of MCS by the investment banking firm of Rotan Mosle, Inc., updated by the appellees' personal assessments of the company's financial prospects based upon their knowledge as company insiders. *Id.* at 283, 287. Though other facts that might have borne upon a valuation decision were brought out at trial,[29] our review of the appellees' testimony regarding their decision-making processes confirms the district court's finding that the decision to pay $200 per share for MCS stock was based upon the appellees' belief that the appraisal remained a fair estimation of market value at the times the stock was purchased.

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29. In their briefs, appellees contend that these facts confirm their decision—we discuss them in detail below. *See* note 42, *infra*.

In its appraisal report, Rotan Mosle stated that it had undertaken to estimate the fair market value of a 100 percent block of MCS stock as of June 30, 1975. Although Rotan Mosle did not explain in detail the actual mechanics of its valuation determination in the report, it did set out the various pieces of information upon which it based its analysis. Principal among these were projections of future revenues and earnings made by MCS management, a comparative financial analysis of MCS and five similar companies, a set of recast MCS financial statements, and a prior offer by a third party to purchase all MCS shares for $158 each. All parties and their expert witnesses agreed that Rotan Mosle's estimate of $200 per share was a reasonable approximation of the fair market value of 100 percent of the MCS stock on the valuation date. The crucial question is whether the fiduciaries prudently determined that it remained so at the time and in the circumstances of the two ESOP transactions, some 13 and 20 months later.

At trial the Secretary mounted a two-pronged attack on the fiduciaries' decisionmaking process. First, he argued that it was imprudent to rely on the Rotan Mosle appraisal because it was out of date by the time of the ESOP transactions—the factual assumptions upon which it was based were no longer valid. In addition, he urged that failure to discount the value ascribed to a 100 percent controlling block of shares when setting the price to be paid for a minority block of shares with no ready market violated general principles of valuation. Based upon several factfindings that we discuss below, the district court rejected the Secretary's arguments. Though we do not find most of these findings clearly erroneous, we do disagree with the district court's legal conclusion:

in our view, the appellees have not shown facts that establish their prudent investigation of the price they paid for MCS stock.

As noted, the Rotan Mosle appraisal was based in part upon revenue and income projections prepared by MCS management. Projected revenue for the 1976 fiscal year was $6.5 million; projected income was approximately $400,000. These figures are based upon actual revenues of $4.2 million for the year ended June 30, 1975, the addition of three or four anticipated new contracts, and a 10-15 percent inflation factor. 541 F.Supp. at 282. Rotan Mosle assumed that this growth rate would continue indefinitely.

Largely due to the fact that the contracts foreseen failed to materialize, actual revenues for the year ended June 30, 1976 totalled only $4.1 million—slightly less than the previous year and significantly less than the projection upon which Rotan Mosle's appraisal was based. Nevertheless, the first ESOP transaction was consummated in August 1976 at the appraised price.

By the time of the February 1977 ESOP transaction, some 20 months after the Rotan Mosle appraisal, the projected revenues still had not materialized. For the seven months ending January 31, 1977, actual revenue was $2.8 million, which, on an annualized basis, would total approximtaely $4.8 million. On the day before the second ESOP transaction, appellee Fritcher, the MCS controller, prepared a schedule of actual and estimated revenue, projecting revenues of $5.3 million for the 1977 fiscal year. His estimate was close—actual revenue for the year ended June 30, 1977, was about $5.6 million. Again, though each of these figures was significantly less than

the performance level that Rotan Mosle had assumed would be achieved a year earlier, the $200 appraised price was paid by the ESOP.

The appellees testified that although they knew that the projections relied upon by Rotan Mosle had not been met, they relied upon knowledge they had gained as managers of MCS to conclude that the company was just as strong, and hence just as valuable, as when Rotan Mosle appraised it. Specifically they stated that they relied upon their knowledge of contract negotiations and their belief that significant new contracts would come "on stream" in the near future. The district court credited this testimony, finding it corroborated by the fact that several significant new contracts were in fact obtained during fiscal 1978 during which MCS collected revenues of approximately $12.6 million. We agree with the district court that appellees were entitled to consider the information available to them by virtue of their management positions at MCS, but we do not agree that their testimony establishes an investigation sufficient to warrant continued reliance on the Rotan Mosle appraisal.

The insufficiency of appellees' investigation lies in their failure to identify the facts and assumptions underlying the Rotan Mosle appraisal and to consider whether they remained valid at the time of the ESOP transactions. Cursory study of Rotan Mosle's report would have shown that they did not in several material respects.

As we have explained, the Rotan Mosle appraisal was based in part upon a projection that MCS revenues would increase from $4.2 million in fiscal 1975 to $6.5 million the following year. That was, however, only the starting point of Rotan Mosle's revenue projection. Much more

important was the assumption, stated clearly in Rotan Mosle's report, that "[i]t is anticipated that this annual growth rate will continue indefinitely." Thus, the continued validity of the $200 appraised stock price was dependent in part upon the *timing* of revenue increases, and not, as the appellees apparently assumed, solely upon whether they could expect to secure the anticipated new contracts at some time in the future.

At the time of the first ESOP transaction, the appellees knew that their growth projection for fiscal 1976 had been much too high—revenues had actually declined. By the time of the second ESOP transaction, it was clear that the 1977 shortfall would be even more significant—still well short of the performance level predicted for the *prior* year. Even if Rotan Mosle had not assumed the company would continue to grow rapidly, these facts should have caused prudent fiduciaries to question whether continued reliance on the Rotan Mosle appraisal was warranted.[30]

In the first place, their own views of the company's prospects had proved overly optimistic for two years running. This should have cautioned them against relying

30. Similarly, the projected growth in income had failed to pan out. Rotan Mosle had assumed that after-tax income would rise from $226,000 to $400,000 during fiscal 1976—an even more dramatic rate of increase (77 percent) than that estimated for revenues—and that this growth rate would continue indefinitely. According to MCS's audited financial statements, actual after-tax income in fiscal 1976 and 1977 was $43,000 and $53,000, respectively. ESOP contributions of $289,000 in 1976 and $318,000 in 1977 were deducted in arriving at these figures. As we explain below, there is some controversy regarding whether ESOP contributions always should be deducted from income for valuation purposes. However, even if the entire ESOP contribution is added back in each year, income remains well below the growth level projected by Rotan Mosle (even without adjustment to eliminate the tax benefit of the ESOP contributions).

so heavily on their own prognostications when investing the money of others. Moreover, even if their claims that they knew of the company's impending economic turnaround are credited, as the district court did, such information would be only the starting point of an inquiry into the continued validity of the appraisal. There is no question that a two-year delay in achieving the performance levels assumed by Rotan Mosle should be considered as a negative factor in such an inquiry—a strong negative, given the size of the revenue and income shortfalls during that period. Appellees apparently did not consider the timing of the new contracts to be important. Their testimony reveals no effort to analyze—either by their own computations or through consultations with advisors—the cumulative effect of this negative factor, together with the positive factor represented by the anticipated contracts, upon the Rotan Mosle appraisal.[31]

Much more important than the appellees' failure to consider the timing of the projected new contract revenue is their failure to take into account the dramatic rate of growth that was built into the Rotan Mosle appraisal analysis. In setting a price of $200 for the MCS stock, Rotan Mosle had assumed that revenues would increase by approximately 55 percent in fiscal 1976—from $4.2 million to $6.5 million—and that this annual growth rate would continue indefinitely. Simple arithmetic shows that at the annual growth rate anticipated by Rotan Mosle, revenues were expected to increase from $6.5 million in fiscal 1976 to $10 million in fiscal 1977 and $15.5 million

31. Obviously, there is some level of growth that would be sufficiently great to offset the effect of any delay in achieving a lower projected increase. However, the appellees had a duty to do more than just assume that such an increase was in the offing.

in fiscal 1978. Thus, even if the appellees are credited with the prescience to have predicted the full $12.6 million of fiscal 1978 revenues prior to the two ESOP transactions,[32] the performance of MCS at levels consistently and significantly below those anticipated by Rotan Mosle should have alerted them that the appraisal was seriously out of date.

The failure of MCS to achieve its projected growth was not the only way in which the assumptions underlying the Rotan Mosle appraisal had significantly changed by the time of the ESOP transactions. The establishment of the ESOP itself was such a change—Rotan Mosle had not assumed that an ESOP existed when it appraised the MCS stock.[33]

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32. It is doubtful that the $12.6 million in actual revenues is the appropriate figure to compare with the Rotan Mosle projections. At least $4 million of that figure is attributable to a contract acquired through a series of transactions with Metro, another Cunningham company. First, MCS purchased all the stock of Metro from Cunningham in exchange for 9,000 shares of MCS stock. *See* note 4, *supra*. A few months later, MCS sold all the Metro stock to Mr. Esparza. In connection with this sale, the parties testified that a large government contract held by Metro was "novated" in favor of MCS. Some $4 million of the 1978 MCS revenues was generated by this contract. Since that revenue was acquired by MCS by virtue of a series of transactions that increased its outstanding stock by 9,000 shares—89 percent—probably it should not be considered in comparing actual revenues with those anticipated by Rotan Mosle. But whether the appellees are deemed to have foreseen 1978 revenues of $12.6 or 8.6 million does not signify; either figure reflects a rate of growth significantly less than that used to establish the $200 price for MCS stock.

33. Although Rotan Mosle's report states that it was "prepared solely to assist management in determining an appropriate common stock value for establishing an Employee Stock Ownership Trust," it is clear that the financial effect of an ESOP was not considered in setting the $200 appraised price. The report makes clear that MCS was appraised "as of" a date before any ESOP was in place. Moreover, while the MCS financial statements were recast to reflect

The most obvious effect that an ESOP will have upon a company is the cash drain represented by the company's contributions to the plan. These contributions represent additional labor cost to the company and hence are not available to the shareholders as profits. Their effect upon the financial condition of the company must be taken into account by fiduciaries in their decision to fund and operate an ESOP. *Eaves v. Penn.*, 587 F.2d 453 (10th Cir. 1978). In *Eaves*, the court held that the trustee of an ESOP breached his fiduciary duties by causing it to enter into a transaction to purchase a majority of the shares of the sponsoring company from its sole owners. To effect the purchase, the trustee in his capacity as an officer of the sponsoring company caused the company to make a large advance contribution to the ESOP. The court found that before its sale to the ESOP the company had enjoyed a strong financial condition but that the large advance ESOP contribution, coupled with the trustee's mismanagement, caused the company to suffer severe financial reverses. 587 F.2d at 456. For these and other reasons, the court held that the trustee violated his fiduciary duty. *Id.* at 462.

In the present case, the appellees testified that it was their intention for the ESOP to purchase 100 percent of the MCS stock over a five to ten year period, possibly in as little as three years, depending upon how quickly

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certain other assumptions about the company's future, such as nonrecurring expenses, no adjustments were made to take into account the effect of an ESOP upon MCS's financial condition. Indeed, there is no other mention of ESOPs in Rotan Mosle's report. Mr. Mark Andrews, the principal draftsman of the Rotan Mosle report, testified: "We valued 100 percent of the stock, and we left it up to the company and its other advisors to determine whether due to the specifics of the ESOP that they eventually set up any discount might or might not be appropriate and we stated that." Andrews depo. at 101.

MCS could earn the money to fund the plan. Thus, at the time of the first ESOP transaction, it was the appellees' intent to cause MCS to transfer $2,020,000 of its earnings within a relatively short period of time (10,100 shares × $200). By the time of the second ESOP transaction, an additional 9,000 shares of MCS stock were outstanding due to the purchase of Metro, *see* note 4, *supra*, so that a total of $3,820,000 (19,100 × $200) would be required to fully fund the ESOP's purchase of MCS. More, by leveraging the second transaction, the appellees rendered MCS's ESOP contributions no longer entirely discretionary—the company became obligated to contribute at least $1 million to the ESOP to amortize the loan from Allied Bank.

The appellees introduced very little evidence of their consideration of the impact of these outflows upon the value of MCS stock. The only committee member to testify on the issue was Mr. Cunningham. In November of 1977, after the ESOP transactions were completed, he had received a letter from Mr. Moroney, an officer of Rotan Mosle, in response to some inquiries he had made. One of the subjects addressed in the letter was Rotan Mosle's treatment of ESOP contributions:

> We do not consider a corporation's contribution to its Employee Stock Ownership Plan an operating expense in the usual sense of the term because the corporation is under no obligation to continue making such contributions. In that respect such contributions resemble dividends, which the corporation may pay or pass in the discretion of its board of directors.

D. Ex. 16. When asked if this subject had been discussed with Rotan Mosle before the ESOP transactions were

entered into, Mr. Cunningham testified that he "believe[d] it came up." When asked if the position taken in the letter was consistent with Mr. Moroney's position prior to the ESOP transactions, Mr. Cunningham replied, "Yes, he's always been consistent." 19 R. at 70.

We will assume that this vague testimony establishes that the appellees received the advice contained in the Moroney letter before consummating the ESOP transactions.[34] This avails them little, however, because, like the Rotan Mosle appraisal report, it was apparent that the assumptions upon which Mr. Moroney's opinion was based did not obtain at the time of the ESOP transactions. Mr. Moroney indicated only that ESOP contributions should be omitted from income computations for valuation purposes when they are discretionary, that is, when the company is not obliged to make them. As we have explained, MCS was obliged to make $1 million in contributions by virtue of the leveraged ESOP transaction. Moreover, the appellees did not intend to make other contributions on a discretionary basis; they all testified that it was their intent from the outset to make contributions sufficient to fund the purchase of all MCS stock by the ESOP in a few years. Since the Rotan Mosle appraisal did not take into account the effects of these contributions, and since the reason the appellees had been given for disregarding such payments was inapplicable in the circumstances, once again we think that

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34. In his deposition, Mr. Cunningham had testified that he could not "swear to" whether this issue had been discussed before the ESOP transactions. Cunningham depo. at 258. Mr. Moroney, the Rotan Mosle officer, testified that he did not think it had been addressed at that time. Moroney depo. at 64.

prudent fiduciaries would have considered themselves on notice that the appraisal should have been updated.[35]

The Secretary also urges us to hold that ESOP fiduciaries must *always* discount the appraised price of a controlling block of stock when less than control is acquired by the ESOP. The Secretary bases his discount argument upon Revenue Ruling 59-60[36] which sets out principles for valuing closely-held stock for estate and gift tax purposes. Two of these principles are that discounts from the price commanded by a controlling block of stock may be appropriate when a minority interest is purchased, or when stock with limited marketability is acquired. 1959-1 Cum. Bull. at 241-42.

[13] Judicial adoption of this revenue ruling is no substitute for the regulations the Secretary has never promulgated; we are unwilling to hold that ERISA fiduciaries who fail to follow it jot and tittle have breached

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35. Another potential cash drain will be occasioned by the operation of an ESOP when the company undertakes to repurchase shares distributed to participants upon termination of their interests in the plan. An enforceable right to require the company to repurchase such shares is known as a "put." Although the Metropolitan ESOP plan document did not grant its participants a put upon termination, all the appellees that testified on the subject stated that their understanding at the time of the ESOP transactions was that MCS would repurchase all stock distributed to terminating plan participants. The district court relied in part upon this intent in holding that a discount for lack of marketability was inappropriate.

Depending upon the number of plan participants, the plan's vesting schedule, and the timing of the termination of the participants' interests, the impact upon MCS cash flow of the stock repurchases anticipated by the appellees could have been significant. As was true regarding the projections and ESOP contributions, the appellees have not shown that they made any attempt to assess the effect of this new factor upon the Rotan Mosle appraisal.

36. 1959-1 Cum. Bull. 237, *modified*, Rev. Rul. 65-193, 1965-2 Cum. Bull. 370.

their duties.[37] Appraisal of closely-held stock is a very inexact science; given the level of uncertainty inherent in the process and the variety of potential fact patterns, we do not think a court should require fiduciaries to follow a specific valuation approach as a matter of law under Section 3(18). The standard they must follow remains one of prudence. If more specific rules are needed, the better—and fairer—approach is to inform fiduciaries of them beforehand by regulation.[38]

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37. Contrary to the Secretary's arguments to us, Revenue Ruling 59-60 itself makes clear that the valuation principles discussed therein are merely factors to be weighed in each case, not *per se* rules to be applied reflexively. "No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock." 1959-1 Cum. Bull. at 237.

38. In support of its conclusion that no discount due to the minority interest was required in this case, the district court held that under ERISA, a fiduciary must discharge his corporate management role in the interests of the plan beneficiaries, 541 F.Supp. at 285, and that if the fiduciary is a control owner, he must deal with his own stock in the interest of the beneficiaries. *Id.* at 286 n. 8. Therefore, the court apparently reasoned that the ESOP would obtain the benefit of effective control ownership by operation of law. These holdings are legally erroneous. As we have explained, ERISA contemplates that fiduciaries will sometimes occupy positions giving rise to dual loyalties; however, by their terms, Sections 404 and 406 impose duties upon these persons *in their capacities as plan fiduciaries*. The cases cited by the district court hold nothing more than this. *NLRB v. Amax Coal Co.*, 453 U.S. 322, 101 S.Ct. 2789, 69 L.Ed.2d 672 (1981); *Donovan v. Bierwirth*, *supra*. "ERISA does not relieve plan fiduciaries of obligations arising out of nonplan relationships. For example, the board of directors and administrators of the employer have responsibilities to others, such as shareholders, that they cannot disregard in favor of plan participants and beneficiaries." 19B *Business Organizations*, S. Young, *Pension and Profit-Sharing Plans* § 17.02[2] at 17-23, 17-24. *See also Curren v. Freitag*, 432 F.Supp. 668, 672 (S.D. Ill. 1977). Similarly, we are unwilling to subject the dealings of such fiduciaries with their own stock to the rigors of scrutiny under ERISA without express congressional direction. We doubt that many potential fiduciaries would be willing to serve if required to deal with their own assets and conduct their own affairs

[14, 15] To sum up, we hold that appellees Cunningham, Fritcher, Hairell, Robertson and Esparza failed to conduct an investigation sufficient to determine if the Rotan Mosle appraisal remained a reasonable approximation of the fair market value of MCS stock at the times they relied on it. Two critical assumptions made by Rotan Mosle—the growth projections and the absence of an ESOP—no longer were valid.[39] Had the appellees com-

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"with an eye single to the interests of the participants and beneficiaries." *Bierwirth*, 680 F.2d at 271.

Whether a discount is appropriate in the circumstances of this case will become important if the district court decides on remand that any monetary relief is appropriate. *See* note 10, *supra*. If it becomes necessary to determine the amount by which $200 per share exceeded adequate consideration, the district court should consider the extent to which its erroneous view of the law affected its determination that a discount was not necessary.

39. The appellees point to several other facts that they say support their contention that adequate consideration was paid by the ESOP. We do not agree that they are sufficient to satisfy appellees' burden of proof in light of their heavy reliance upon the defective appraisal.

Cunningham asserts that his exchange of Metro shares for MCS shares at the rate of $200 per share in January of 1977 establishes that the price was adequate. *See* note 4, *supra*. It does not. Cunningham remained in control of MCS both before and after the transaction. Moreover, by virtue of the first ESOP transaction in August 1976, he knew that the ESOP would provide a ready market at $200 for the MCS shares he acquired for Metro; indeed, he sold 5,000 more shares to the ESOP at that price less than a month later. The Metro exchange was simply not the sort of arms-length transaction that can serve as a barometer of fair market value.

The appellees also argue that evidence of certain stock options granted to two MCS employees verify a price of $200 per share. We think the most telling answer to this contention is that when asked to explain the basis of their decision that the Rotan Mosle appraisal remained valid, none of the appellees cited the options as a factor. Even if they had been considered, they are slim indications of fair market value. Fritcher had been granted an option to buy 500 shares in 1974 at $140 per share. However, he did not exercise it, choosing instead to take the difference between $140 and $200 per share in cash. Though indicative that the shares were not thought to be worth

pared the 17-page Rotan Mosle report and its exhibits with the information at their disposal when they bought MCS stock for the ESOP, they should have realized this. In these circumstances, it was not enough for fiduciaries simply to rely on their generalized notions that the company's prospects were good. The appraisal represented a quantitative analysis of specific facts and assumptions. Prudent fiduciaries would have sought to analyze the effect of obvious changes in those facts and assumptions—either by their own efforts or with the help of advisors. An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly. To use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock—they are entitled to rely on the expertise of others. *See* note 26, *supra*. However, as the source of the information upon

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more than $200, this transaction does not establish that they were not worth much less—incentive stock options are frequently granted at prices in excess of current fair market value as an inducement for employees to work to increase the value of the company. They are not proxies for arms-length transactions. For the same reason, an option to purchase stock at $200 per share granted to Perrin in mid-1977 is equally unpersuasive.

Finally, the appellees urge that two bona fide arms-length offers to purchase all the MCS stock corroborate their determination that $200 per share was adequate consideration. Only one of these offers occurred before the ESOP transactions: in April 1975, MCS received an offer to purchase the entire company for $1.6 million or $158 per share. Significantly, the Rotan Mosle report stated that its evaluation was based in part upon this offer. Accordingly, the offer is not additional information that the appellees could have used to evaluate the continuing validity of Rotan Mosle's conclusion. It does nothing to offset the facts that we have discussed which show that the appellees should have questioned the appraised figure. The second offer from a third party—$162.50 per share—came in 1979, long after the ESOP transactions, and could hardly have been a factor in the appellees' decision.

which the experts' opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date. In failing to do so, the appellees breached their duties of prudence under Section 404 and likewise cannot establish that they paid adequate consideration. Accordingly, the ESOP transactions also were prohibited by Section 406.

Liability of Successor Fiduciaries

Appellees Carter and Perrin became members of the administrative committee of the Metropolitan ESOP after the challenged ESOP transactions had taken place. The Secretary alleged that Carter and Perrin knew that the other appellees had breached their fiduciary duties in connection with those transactions and that Carter and Perrin had therefore violated Section 405 of ERISA by concealing those breaches and by failing to remedy them.[40]

[16, 17] In view of its conclusion that the other fiduciaries had not breached their duties, the district court

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40. Section 405(a) provides for the liability of cofiduciaries in various circumstances:

> In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:
>
> (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
>
> (2) if, by his failure to comply with section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or
>
> (3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

29 U.S.C. § 1105(a) (1976).

held that Carter and Perrin had not violated Section 405. Our decision that the other appellees acted in violation of ERISA necessitates reconsideration by the district court of the allegations against Carter and Perrin. Section 405 does not impose vicarious liability—it requires actual knowledge by the co-fiduciary. "Under this rule, the fiduciary must know the other person is a fiduciary with respect to the plan, must know that he participated in the act that constituted a breach, and must know that it was a breach." H.R. Rep. No. 1280, *supra*, 1974 U.S. Code Cong. & Ad. News at 5080. The knowledge of Carter and Perrin is a question of fact for the district court to resolve on remand, either on the record as it stands or supplemented as the district court in its discretion deems necessary.

Attorneys' Fees

[18] *Award to Defendants.* The district court awarded costs and attorneys' fees against the government in favor of the defendants under the Equal Access to Justice Act. 28 U.S.C. § 2412(a) and (b) (Supp. 1983). Since under our decision today the defendants no longer remain "prevailing parties," that award must be reversed.

Award to Allied Bank. The Secretary did not take any action against Allied Bank, the trustee of the Metropolitan ESOP. Appellees Cunningham, Hairell and Robertson brought a third-party complaint against Allied Bank, alleging that it was liable as a co-fiduciary and seeking contribution and indemnity. Allied Bank denied any breach of fiduciary duty and counterclaimed for indemnity, costs and attorneys' fees. The district court awarded costs and

attorneys' fees to Allied Bank against Cunningham individually under ERISA Section 502(g).[41]

[19, 20] An award of attorneys' fees under Section 502(g) is reviewable only for abuse of discretion. *Iron Workers Local No. 272 v. Bowen*, 624 F.2d 1255, 1264-66 (5th Cir. 1980). Among the factors that should inform a district court's exercise of discretion are:

> (1) the degree of the opposing parties' cupability or bad faith; (2) the ability of the opposing parties to satisfy an award of attorneys' fees; (3) whether an award of attorneys' fees against the opposing parties would deter other persons acting under similar circumstances; (4) whether the parties requesting attorneys' fees sought to benefit all participants and beneficiaries of an ERISA plan or to resolve a significant legal question regarding ERISA itself; and (5) the relative merits of the parties' positions.

Id. at 1266 (footnote omitted).

[21] In its opinion, the district court reviewed the merits of the third party claims against Allied Bank and explained its conclusion that Cunningham should pay the bank's litigation expenses: "The court has determined that the award is appropriate in such form because the third party actions against Allied were unfounded and were designed it appears only to secure Allied's presence in the suit to aid in defense of the primary suit. Further, Cunningham is in the financial position to satisfy the award of fees and costs while the other defendants are

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41. "In any action under this subchapter by a participant, beneficiary, or fiduciary, the court in its discretion may allow a reasonable attorney's fee and costs of action to either party." 29 U.S.C. § 1132 (g) (1976).

not." 541 F.Supp. at 290. We have reviewed the relevant portions of the record and agree with the court's stated analysis of the merits of the third party claims. *See id.; see generally Robbins v. First American Bank of Virginia,* 514 F.Supp. 1183, 1189-91 (N.D. Ill. 1981) (collecting cases). We therefore conclude that its award was not an abuse of discretion.[42]

Conclusion

The judgment of the district court in favor of appellees Cunningham, Fritcher, Hairell, Robertson and Esparza on the Section 404 and 406 claims is REVERSED, and the cause is REMANDED for the district court in its discretion to determine the appropriate relief to be afforded the Secretary. The judgment in favor of appellees Carter and Perrin is VACATED and the cause is REMANDED for further proceedings consistent with this opinion. The award of attorneys' fees to the appellees is REVERSED. The award of attorneys' fees to Allied Bank is AFFIRMED.

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42. Accordingly, we need not reach the claim raised in Allied Bank's cross-appeal that its fees and costs are recoverable under indemnity agreements executed by MCS and Cunningham. *See* 541 F.Supp. at 289-90.

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 82-2296

Raymond J. DONOVAN, Secretary of the
United States Department of Labor,
Plaintiff-Appellant Cross-Appellee,

v.

Kenneth R. CUNNINGHAM,
Defendant-Third Party Plaintiff-Appellee-Cross-Appellant,

L. J. Carter and Mark W. Perrin,
Defendants-Third Party Plaintiffs-Appellees-
Cross-Appellants-Cross-Appellees,

Salvador Esparza and Edward F. Fritcher,
Defendants-Third Party Plaintiffs-
Appellees-Cross-Appellants,

v.

Wilford H. HAIRELL and A. Mitchell Robertson,
Defendants-Third Party Plaintiffs-Appellees-
Cross-Appellants-Cross-Appellees,

v.

ALLIED BANK OF TEXAS,
Third Party Defendant-Cross-Appellee-Cross-Appellant,

v.

METROPOLITAN CONTRACT SERVICES, INC.,
Third Party Defendant-Cross-Appellee.

Appeals from the United States District Court
for the Southern District of Texas

ON PETITION FOR REHEARING

(December 2, 1983)

Before THORNBERRY, GEE and WILLIAMS, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

ENTERED FOR THE COURT:

/s/ THOMAS GIBBS GEE
United States Circuit Judge

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 82-2296

Raymond J. DONOVAN, Secretary of the
United States Department of Labor,
Plaintiff-Appellant Cross-Appellee,

v.

Kenneth R. CUNNINGHAM,
Defendant-Third Party Plaintiff-Appellee-Cross-Appellant,

L. J. Carter and Mark W. Perrin,
Defendants-Third Party Plaintiffs-Appellees-
Cross-Appellants-Cross-Appellees,

Salvador Esparza and Edward F. Fritcher,
Defendants-Third Party Plaintiffs-
Appellees-Cross-Appellants,

v.

Wilford H. HAIRELL and A. Mitchell Robertson,
Defendants-Third Party Plaintiffs-Appellees-
Cross-Appellants-Cross-Appellees,

v.

ALLIED BANK OF TEXAS,
Third Party Defendant-Cross-Appellee-Cross-Appellant,

v.

METROPOLITAN CONTRACT SERVICES, INC.,
Third Party Defendant-Cross-Appellee.

Appeals from the United States District Court
for the Southern District of Texas

(Filed December 22, 1983)

ORDER

The motion of APPELLEES for stay of the issuance of the mandate pending petition for writ of certiorari is DENIED.

/s/ THOMAS GIBBS GEE
United States Circuit Judge

APPENDIX D

Raymond J. DONOVAN, Successor to Ray Marshall, Secretary of the United States Department of Labor,

v.

Kenneth R. CUNNINGHAM, et al.

Civ. A. No. H-80-87

United States District Court
S. D. Texas
Houston Division

May 21, 1982.

* * *

MEMORANDUM AND ORDER

SINGLETON, Chief Judge.

This cause was filed January 14, 1980 by the Secretary of the United States Department of Labor against the members of the Administrative Committee of the Employee Stock Ownership Plan (ESOP) of Metropolitan Contract Services, Inc. (MCS). The defendants were either members of the Administrative Committee at the time of the two stock transactions which form the basis of the complaint or became members shortly afterwards.

The action arises under the Employee Retirement Income Security Act of 1974 (ERISA), as amended, 29 U.S.C. 1001 et seq. The plaintiff, Secretary of the Department of Labor, bases his case on various specific provisions of ERISA.

The plaintiff seeks comprehensive relief; that the defendants be enjoined from any acts in violation of their fiduciary duties under ERISA; that the defendant restore the Plan to its rightful economic place by rescission of the stock sales in question, and that the money paid to Defendant Cunningham by the Plan be returned to the Plan together with interest; that the Defendants Cunningham, Carter, Hairell, Perrin, and Robertson be removed as fiduciaries of the Plan and that all defendants be permanently enjoined from serving as fiduciaries with respect to this Plan, and for an additional period of five years that they be enjoined from serving as fiduciaries of any other employee benefit plan covered by ERISA and that the court appoint an independent successor fiduciary to administer and manage the Plan assets and for costs and general relief.

Defendants L. J. Carter and Mark W. Perrin brought a third-party action against Allied Bank of Texas (Allied), the Plan trustee at all times relevant to this lawsuit, on the grounds that if they were found liable for violations of ERISA, then in that event Allied would be liable to them on various theories; also Defendants Salvadore Esparza, Edward F. Fritcher, Perrin and Carter brought third-party actions against MCS and a cross-action against Defendant Cunningham claiming in essence that they were indemnified by certain documents and instruments in the event they were found liable for fiduciary breaches.

Allied, as counter-plaintiff and third-party plaintiff, brought suit against MCS and its ESOP as third-party defendants and against Defendants Cunningham, Wilford H. Hairell, A. Michael Robertson, Perrin and Carter, as counter-defendants, claiming indemnity under an agree-

ment entered into between Defendant Cunningham and Allied with respect to a loan made to the ESOP to finance one of the stock purchases in question and based on Plan indemnification provisions which Allied claims indemnifies it generally in connection with its service as trustee of the MCS ESOP.[1] Additionally, Allied seeks recovery of its fees and expenses incurred in defense of this suit under the indemnity agreements and under section 502(g)(1) of ERISA, 29 U.S.C. 1132(g)(1).[2]

The defendants except Cunningham have applied under the newly enacted Equal Access to Justice Act, 28 U.S.C. 2412(d)(1)(A)[3] for fees and expenses incurred in this suit. Defendant Cunningham has applied for attorney's fees and expenses under section 502(g)(1) of ERISA,

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1. Metropolitan Contract Services, Inc. Employee Stock Ownership Plan, section 17G (upon which Allied bases its claim for indemnity from MCS) provides in pertinent part:

> The Company shall indemnify each member of the Board of Directors, each member of the Committee, the trustee and any other person to whom any fiduciary responsibility with respect to the plan is allocated or delegated from and against any and all liabilities, costs, and expenses incurred by such persons as a result of any act or omission to act in connection with the performance of their fiduciary duties, responsibilities and obligations under the Plan and under the Act except for liabilities and claims arising from such fiduciary's willful misconduct.

2. Section 502(g)(1) of ERISA, 29 U.S.C. 1132(g)(1) provides in pertinent part:

> In any action under this subchapter . . . by a participant, beneficiary or fiduciary, the court in its discretion may allow a reasonable attorney's fee and costs of action to either party.

3. 28 U.S.C. 2412(d)(1)(A) provides in pertinent part:

> . . . a court shall award to a prevailing party . . . fees and other expenses . . . incurred by that party in any civil action brought by or against the United States . . . unless the court finds that the position of the United States was substantially justified or that special circumstances make an award of fees unjust.

29 U.S.C. 1132(g)(1) and 28 U.S.C. 2412(a) and (b).[4]

Essentially, plaintiff claims that, by causing the ESOP to purchase 1440 shares of MCS on August 11, 1976 and 5000 shares of MCS on February 18, 1977 from Kenneth R. Cunningham for $200.00 per share, defendants (excepting Perrin and Carter) violated ERISA. Specifically plaintiff alleged that Defendants Cunningham, Esparza, Fritcher, Hairell, and Robertson breached their fiduciary obligations by failing to discharge their duties with respect to the ESOP solely in the interest of its participants and with the proper care in violation of section 404(a)(1)(A) and (B) of ERISA, 29 U.S.C. 1104(a)(1)(A) and (B) by:

1. failing to follow the procedures necessary to determine the fair market value of the shares of MCS sold to the ESOP and
2. causing the ESOP to pay defendant Cunningham more than adequate consideration for the purchase of the shares.

Section 404(a)(1) of ERISA 29 U.S.C. 1104(a)(1) provides in pertinent part that:

> . . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

4. 28 U.S.C. 2412(a) provides in pertinent part:
. . . a judgment for costs, . . . but not including the fees and expenses of attorney's, may be awarded to the prevailing party in any civil action brought by or against the United States . . .
28 U.S.C. 2412(b) provides in pertinent part:
. . . a court may award reasonable fees and expenses of attorneys, in addition to the costs which may be awarded pursuant to subsection (a), to the prevailing party in any civil action brought by or against the United States . . .

A. for the exclusive purpose of

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

B. with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

Plaintiff also alleged that Defendants Cunningham, Esparza, Fritcher, Hairell, and Robertson failed to discharge their fiduciary duties in accordance with the documents of the ESOP in violation of section 404(a)(1)(D) of ERISA, 29 U.S.C. 1104(a)(1)(D).

Plaintiff further alleged that Defendants Cunningham, Esparza, Fritcher, Hairell, and Robertson caused the ESOP to engage in transactions which constituted sales of property between the ESOP and a party in interest in violation of section 406(a)(1)(A) of ERISA, 29 U.S.C. 1106(a)(1)(A) and which constituted transfers of the ESOP assets to a party in interest in violation of section 406(a)(1)(D) of ERISA, 29 U.S.C. 1106(a)(1)(D) by causing the ESOP to purchase the MCS stock from Defendant Cunningham for more than adequate consideration. Section 406(a)(1) of ERISA, 29 U.S.C. 1106(a)(1), entitled "Prohibited transactions," provides in pertinent part that:

> . . . a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—

> A) sale or exchange, or leasing, of any property between the plan and a party in interest; [or]
>
> B)-C) . . .
>
> D) transfer to, or use by or for the benefit of a party in interest, of any assets of the plan . . .

Plaintiff further alleged that Defendant Cunningham dealt with the assets in his own interest or for his own account in violation of section 406(b)(1) of ERISA, 29 U.S.C. 1106(b)(1), and acted on behalf of a party whose interests are adverse to the interests of the Plan or the interests of its participants or beneficiaries in violation of section 406(b)(2) of ERISA, 29 U.S.C. 1106 (b)(2) by his participation in causing the ESOP to purchase the MCS stock from him for more than adequate consideration.[5]

Finally Plaintiff alleged that Defendants Carter and Perrin are liable pursuant to section 405(a)(1) and (3) of ERISA, 29 U.S.C. 1105(a)(1) and (3) for breaches committed by the other defendants.

Section 405(a) of ERISA, 29 U.S.C. 1105(a) provides, in pertinent part, that;

> . . . a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:
>
> 1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such

5. The prohibitions of section 406 of ERISA, 29 U.S.C. 1106 do not apply to certain transactions where the consideration paid is not more than adequate. Section 408(e)(1) of ERISA, 29 U.S.C. 1108 (e)(1).

other fiduciary, knowing such act or omission is a breach; [or]

2) . . .

3) if he has knowledge of a breach by such other fiduciary unless he makes reasonable efforts under the circumstances to remedy the breach.

The cause was tried to the bench for six days beginning December 16, 1981. Based upon the evidence adduced at trial, including depositions cited to the court by plaintiff, and upon a thorough review of the file along with relevant precedent, this court makes the following findings of fact and conclusions of law.

FINDINGS OF FACT

Metropolitan Contract Services, Inc. (MCS) is a contract trucking company which, at all times relevant to this action, has provided deivery services for department stores in the southern and western parts of the country. The business was started in 1964 by Defendant Kenneth R. Cunningham and was subsequently sold to a separate corporation called Illustrated World Encyclopedia, Inc. In May, 1973 Defendant Cunningham repurchased the assets of MCS for approximately $500,000. By the close of the fiscal year ended June 30, 1974, the company's business primarily entailed bulk deliveries of retail merchandise such as furniture, appliances and other goods too large to be delivered as packages by a common carrier. The bulk deliveries typically were made from department stores, where the goods were purchased, to the consumers who purchased those goods. The deliveries were made pursuant to contracts between the department stores and MCS.

As of June 30, 1975, Defendant Cunningham was chairman of the board, chief executive officer, president, and sole shareholder of MCS. Defendant Fritcher was secretary/treasurer and comptroller of MCS; Defendants Hairell and Robertson were vice presidents; and Defendant Perrin was counsel to MCS. In 1975, 1976, and 1977, Defendants Cunningham, Esparza, Fritcher, Hairell, and Robertson were also members of the MCS board of directors. In late 1976 or early 1977, Defendant Carter became comptroller of MCS.

From 1972 until mid-1977, Defendant Cunningham was sole shareholder of a separate company called Metro Contract Services, Inc. (Metro). Metro provided logistical support to government facilities, pursuant to cost plus contracts. Those contracts were generally for three year terms and were governed by applicable federal law, including the Service Contract Act and various procurement regulations. As of December 31, 1976, Cunningham was chairman of the board and chief executive officer of Metro; Esparza was president and chief operating officer, and Fritcher was secretary, treasurer, and chief financial officer.

Although, after 1975, other shareholders (including the ESOP) obtained shares in the company, MCS has never issued a dividend.

On December 15, 1975 (effective July 1, 1975), the Board of Directors of MCS voted to establish an employee stock ownership plan "in order to enable participating employees of the corporation to share in the growth and prosperity of the company and to provide the participants with an opportunity to accumulate ad-

ditional resources for their retirement." Unanimous Consent of Directors, Dec. 15, 1975.

In deciding to establish the ESOP, defendants (in their capacity as directors of MCS) consulted with and received advice from a number of professionals. Those professionals included private consultants, attorneys, and accountants.

In establishing the ESOP Defendant Cunningham intended to sell 100% of his Metropolitan stock to ESOP, over some period of time. While there was no written document setting forth any such intent or obligating Cunningham to execute this stated intent or requiring sale of all the stock over any particular period of time, the testimony of the various committee members established that 100% of the MCS stock would be transferred to the ESOP as quickly as it could be done in an orderly, undisruptive, and efficient fashion. The source of funds for the purchase of the stock was MCS contributions to the ESOP. Therefore the profitability of MCS operations would primarily determine the period over which the full purchase of MCS stock would occur.

Cunningham's credible testimony that he intended the expeditious sale of 100% of MCS to the ESOP is corroborated by the fact that he had sold the predecessor to MCS to Illustrated World Encyclopedia, Inc. in 1971 and after the repurchase in 1973 had solicited bids for a sale of MCS more recently, prior to creation of the MCS ESOP.

In August of 1975, the investment banking firm of Rotan Mosle, Inc. was hired by MCS to appraise the

fair market value of the 100% block of MCS stock owned by Defendant Cunningham, as of June 30, 1975. Rotan Mosle has substantial expertise in stock evaluations of all types and may be considered neutral on the evaluation of the MCS shares. Rotan Mosle estimated the fair market value of that 100% at $2,020,000. or $200 per share, based on 10,100 shares outstanding (all owned by Defendant Cunningham). The appraisal was issued in November 1975. Plaintiff's expert, Mr. Paul Much, agreed that the Rotan Mosle evaluation was accurate for a 100% block as of June, 1975.

Rotan Mosle's valuation was in part premised on management's projection, as of June 30, 1975, that gross revenues for the coming fiscal year would be $6.5 million. The $6.5 million projection was reached by adding several components: (a) actual revenues of $4.2 million for the year ended June 30, 1975, plus (b) addition of 3 to 4 new contracts, plus (c) 10-15% increase in current revenues due primarily to inflation.

On August 6, 1976, defendants in their capacity as the Board of Directors, voted to contribute some $288,000 to the ESOP for the purpose of enabling the ESOP to purchase 1,440 shares of MCS stock from Defendant Cunningham. On that same day the Administrative Committee, excluding Cunningham, voted to purchase those shares at $200 each, for a total payment of $288,000 in cash. On or about August 11, 1976, the sale and purchase actually occurred. The block of 1,440 shares comprised about 14% of the total outstanding shares at that time (10,100).

Defendants based their decision to pay $200 per share on the June, 1975 Rotan Mosle appraisal and

upon their individual assessment of the company's financial condition and prospects. By August, 1976 when the shares were sold to the ESOP, MCS's actual revenues for the fiscal year ended June 30, 1976 were below the projected revenues assumed in the Rotan Mosle appraisal. However, each defendant who testified stated that he fully expected certain large contracts to come on stream soon after that time and that the difficulties which the company experienced in fiscal year ending June 30, 1976 would be overcome. Subsequent events proved their foresight correct.

On February 9, 1977, just prior to the second sale of stock to the ESOP, MCS issued an additional number of shares to Cunningham and, in exchange, acquired from him all outstanding shares of Metro.

The exchange of stock was accomplished in the following manner: On January 3, 1977, the directors of MCS, including Cunningham, authorized the company to issue an additional 9,000 shares of stock (bringing the total outstanding to 19,100), and further authorized distribution of all 9,000 shares to Cunningham. In exchange for these 9,000 shares, Cunningham transferred to MCS all of the 25,000 outstanding shares of Metro. As noted above, Cunningham was sole owner of all Metro shares. As stated in the minutes of the directors' meeting of January 3, 1977, it was the intention of the Board that the exchange of stock would qualify as a tax-free reorganization under the Internal Revenue Code, and that as a result of the exchange, Metro would become a wholly owned subsidiary of MCS, i.e., MCS would own all shares of Metro.

Sometime prior to January 3, 1977, Cunningham had a telephone conversation with Robert Moroney, an appraiser at Rotan Mosle, in which the two men discussed the fair market value of the 25,000 shares of Metro. Mr. Moroney informed Cunningham that in his opinion, the value of 100% of Metro was $1.8 million as of December 31, 1976. Mr. Moroney later confirmed that telephone conversation by letter. It is a significant fact that just prior to the second sale of MCS stock to the ESOP Cunningham transferred 100% of Metro valued at $1.8 million for 9000 shares of MCS.[6]

On February 18, 1977, upon the vote of the Administrative Committee, excluding Cunningham, the ESOP purchased an additional 5,000 shares from Cunningham, at $200 per share, for a total of $1 million.

Defendants relied on the Rotan Mosle appraisal, and upon their individual assessments of the company and their prognoses as the basis for determining that that purchase was for adequate consideration. By February 1977, the number of outstanding shares of MCS stock had increased to 19,100 so the 5,000 shares sold to the ESOP comprised a minority block (of approximately 26%). After the sale, the ESOP owned a total of 6,400 shares, or roughly 34% of the outstanding shares, and Cunningham owned 12,660 or some 66%.

This second ESOP transaction was financed through a $1 million loan to the ESOP from Allied Bank. The

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6. Kenneth Cunningham, in his deposition at page 200, stated that he believed he relied on the Metro appraisal in deciding on the $200 per share price for the MCS stock. While the exchange of the Metro stock for MCS stock does not alone establish a price for MCS stock it does bear directly and positively on defendants' good faith in the transaction between Cunningham and the ESOP.

promissory note to Allied for this $1 million loan, payable by the ESOP, required payment of $200,000 annually over a maximum term of five years, at an interest rate of a half point over prime. In connection with the loan, MCS agreed to make sufficient contributions to the ESOP to enable it to meet its payments to the Bank. The loan was actually repaid in under one year through contributions by MCS.

There is no evidence that defendants Perrin and Carter knowingly participated in or sought to conceal any acts of the other defendants which acts plaintiff alleges were breaches of the defendants' fiduciary responsibilities to the plan participants and beneficiaries.

FINDINGS OF FACT RELATING TO EVALUATION OF MCS STOCK SOLD TO ESOP

[1] Evaluation of the stock of a closely held corporation is an inexact endeavor. The statutory prescription for ascertaining adequate consideration is found in section 3(18)(B) of ERISA, 29 U.S.C. 1002(18)(B). Under this section fair market value must be determined in good faith pursuant to the terms of the Plan. The Plan in this case provides for procedure identical to that found in section 3(18)(B) of ERISA, 29 U.S.C. 1002(18)(B) except that, additionally, any interested party shall not participate in the vote or decision concerning a transaction in which he is interested. The section further provides that value is to be determined in accordance with regulations promulgated by the Secretary of the Department of Labor. The Secretary has not promulgated regulations for ascertaining the fair market value of a security for which there is no generally recognized market, there-

fore, evaluation must be undertaken in good faith without the guidance of formalized procedure specifically established for ERISA. This court interprets good faith to entail not only the sole motivation of benefiting the ESOP but also the application of sound business principles of evaluation.

[2] The court has reviewed numerous procedures for comprehensive evaluation of stock, in a closely held corporation.[7] These procedures provide a suitable point of departure in valuing the stock intended for transfer to an employee stock ownership plan. However, the unique circumstances of a transfer of shares to an employee benefit plan require divergence from usual evaluation techniques. In a stock transfer to a benefit plan, the particular economic and legal relationship between the buyer and seller, the goals of shifting ownership to employees, and the need for reasonable valuation techniques which are fair and which do not inhibit establishment of such benefit plans are all factors which weigh uniquely upon valuation.

[3] One figure agreed upon by both sides to the lawsuit is $200.00 per share as of November 1975, which value was suggested in the Rotan Mosle appraisal of November 1975 for a 100% block of MCS stock. The plaintiff's expert, Mr. Paul Much, considers a substantial discount from this $200.00 figure to be necessitated by the fact that the interest transferred would be a minority share and thus subject to manipulation and exploitation by the control block owner. Minority ownership may

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7. See generally 26 C.F.R. 20.2031 2(f)(2), Maher, *An Objective Measurement For a Discount For a Minority Interest and a Premium For a Controlling Interest*, 47 Taxes 449 (1979), Mahoney, *Why 25% Discount For Non-Marketability in One Valuation, 100% in Another*, 55 Taxes 316 (1977).

carry an implicit discount in an arms length third party sale, however this court considers the financial considerations which obtain to such a third party sale to be largely inapplicable to these sales to the MCS ESOP. Minority ownership can certainly justify discount of shares in the possession of an ESOP, however the MCS ESOP is distinct. As noted above the court finds that the Administrative Committee intended to purchase for the ESOP, and Cunningham intended to sell to the ESOP, 100% of the MCS stock. This intent to transfer the full ownership to the ESOP within a relatively short period greatly attenuates the disparity in stock value which would exist if the transfer were between Cunningham, as controlling shareholder, and an independent third party.

Further there is no evidence of the exploitation of corporate perquisites which is a frequent attribute of control ownership. Neither the salary commanded by Cunningham or his associate Mr. Tomlinson nor the payments to another Cunningham corporation, Jet Travel, Inc. may be characterized as excessive use or diversion of corporate funds.

The court further finds that there is no evidence that Defendant Cunningham influenced or attempted to influence the other members of the Administrative Committee in the evaluation or purchase of Cunningham's MCS stock.

[4, 5] Mr. Much argues that control ownership carries with it the privilege of making unfettered important corporate decisions. However this is a control ownership prerogative only among independent parties. Where an individual, who is in a corporate decision making position, is also a fiduciary to an employee benefit plan, it

is clear under the law of ERISA that that fiduciary may not discharge his corporate management role without full consideration of and respect for the interests of the beneficiaries of the plan. *N. L. R. B. v. Amax Coal Co.*, 453 U.S. 322, 101 S.Ct. 2789, 69 L.Ed.2d 672 (1981), *Woods v. City National Bank & Trust Co.*, 312 U.S. 262, 61 S.Ct. 493, 85 L.Ed. 820 (1941), *Donovan v. Bierwirth, et al*, 538 F.Supp. 463 (E.D.N.Y.) December 3, 1981. Therefore, the usual power accorded control ownership is substantially circumscribed by the legal obligation which the control owner owes to the plan beneficiaries and accordingly any discount which could be generally applicable because of such control will be greatly reduced or eliminated in a situation involving a transfer of stock to a plan by a fiduciary of the plan.

[6-9] Additionally, Mr. Much places great emphasis, in reaching his conclusion on the fair market value of the MCS stock, on the size of the blocks transferred and on the marketability of those blocks. Mr. Much suggests that as of June 30, 1975 a comparable publicly held stock would be valued at $124.00 per share and a privately held stock would be valued at $80.00 per share while stock in an ESOP with a discretionary put would be $105.00 per share. With these figures as starting points Mr. Much goes on to find values of $71.00 and $88.00 per share for August 1976 and February 1977 respectively.[8] This estimate of the stock's value in the hands of the

8. This court disagrees fundamentally with Mr. Much's apparent stance that valuation for ESOP purposes mirrors that for other purposes except in ways which require a greater discount for an ESOP valuation. See Valuation Report p. 4 where Mr. Much states that the additional labor costs and financing arrangements should be considered. Certainly these considerations are relevant, however the unique attributes of ESOP purchase and ownership militate against the most substantial of Mr. Much's arguments for significant discounts in this

ESOP is completely arbitrary and unreliable in view of Mr. Much's obvious prejudice in favor of attaining a valuation which supports the theory of the Department of Labor. In view of the certain intent to transfer all the

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valuation. Mr. Much arrives at the 1976 and 1977 values through an analysis of:

1) The company's actual sales and earnings for the fiscal year ending June 30, 1976 as compared with management's projection for that period;

2) MCS future outlook as of the respective dates of the transfers of MCS shares to the ESOP;

3) MCS operating performance relative to those of five comparable public companies;

4) the lack of marketability of a minority position in MCS as a private company.

[Plaintiff's exhibit 68A, Valuation Report, pages 15 and 22.] Mr. Much, in reaching the values for MCS stock for 1976 and 1977 stresses the fact that projected sales and earnings failed to materialize. Mr. Much conceded that the lower sales and earnings figures resulted in part from the failure to gain three anticipated contracts and from time lags associated with bringing on new customer contracts that ultimately were obtained. He further suggests that the failure of MCS to achieve any net gains between 1975 and 1976 would result in investor skepticism towards projections for subsequent years. Therefore the "attractiveness of an investment in Metropolitan would decrease with a resultant negative valuation impact". Valuation Report, p. 17. This argument is flawed. An argument central to the government's case is that the diminished actual sales and earnings for 1976 justified a significant discount. The government's expert concedes that new contracts projected for 1976, but unrealized, would likely develop in fiscal 1977 (and the court has determined that the defendants were reasonable in reliance on the anticipated contracts). Notwithstanding the actual financial condition of MCS, Mr. Much maintains that because it failed to meet its projections for 1976 investors would be unwilling to accept the new revenue and earnings prospects.

In a stock transfer to this ESOP, this position is not sustainable. Reference to an independent, third party sale provides only a backdrop for valuation in a sale to the ESOP. In a bargaining context, the tensions of the marketplace might permit an independent purchaser to discount such information about new contracts. However, this is an essential point where ESOP valuation procedure and non-ESOP valuation procedure diverge. The agents of the purchaser here were the persons who generated the new contracts. They, uniquely, were aware of the implication of these contracts to MCS's financial picture.

MCS stock over a short period, the marketability difficulties a minority block might experience generally, are not present. In this regard, though neither MCS nor the ESOP was obligated to repurchase shares of MCS received by employees from the ESOP, there is an indication that the company would purchase the shares when they were distributed to employees and had done so on the infrequent occasion when an employee requested.[9]

It is understood that these contracts would largely rectify the financial difficulties experienced in fiscal 1976. Investor skepticism therefore, in this case cannot be reasonably considered to be such a factor.

Further Mr. Much, in his written valuation report at p. 2 stated a control shareholder may "dictate management policy, determine levels of compensation, set dividend policies according to personal preference, and force the sale of the entire company" which powers justify a premium for such ownership. The court specifically finds that no exploitation of control prerogative did in fact occur and further notes that, under the law of ERISA (as discussed in the body of this opinion at p. 285), in fact the control owner, where such owner is also a fiduciary as here, does not possess these unfettered powers. If a control owner/fiduciary does act in a manner which detriments the participants and beneficiaries of the ESOP, he may breach the standards of care imposed by ERISA, section 404, 29 U.S.C. 1104. However, the existence of these comprehensive statutory standards to weigh the actions of a control owner/fiduciary raises entirely different implications for valuation for ESOP purposes than would apply in a sale between a control owner and an independent third party.

A control owner's exercise of these powers to his sole benefit is not consistent with the discharge of fiduciary duties solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries. The control owner cannot serve two masters. The establishment of an ESOP requires at least equal obeisance to the beneficiaries of the Plan. This statutory proscription effectively invests the Plan and its beneficiaries with a power which substantially counterbalances that of the control owner by virtue of its ownership position. This fact coupled with the certain intent in this case to quickly transfer 100% ownership to the ESOP strongly undermines the argument that a discount in value is mandatory due to minority ownership.

9. Mr. Cunningham so stated in trial and in his deposition at pg. 88. Additionally Mr. Much notes in the Valuation Report at pg. 30, the company had a "probable intent" to repurchase the share dis-

[10] Evaluating the totality of the evidence and the credibility of the witnesses, particularly Mr. Cunningham and the other members of the Board of Directors and Administrative Committee of MCS, it is the opinion of this court, that each defendant conducted himself in good faith with dedication to the ESOP participants and beneficiaries.

[11] The viability of a service corporation of this size usually depends upon the business acumen of its management team. The members of the management team are generally in the most advantageous position to estimate a company's potential. When their estimation is undertaken in good faith, the resulting opinion of value carries great weight. Each defendant who testified indicated that in arriving at a value for the stock he considered the company's prospects as he saw them at the time of the evaluation. While the court must evaluate the fiduciaries' prudence at the time of the inquiry into the stock value, it is certainly relevant to the reasonableness of the determination of the fair market value that the individual prognoses of the company's imminent prosperity proved to be accurate. Therefore the shortfall in revenues from that projected in the Rotan Mosle appraisal for the year of the stock transactions does not, in view of the counterposing assessment of company growth by the management team, necessitate, as a matter of common business sense, a discount in stock value. The plaintiff's argument in this

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tributed and because of this intent Mr. Much lowered the discount applicable due to lack of marketability. However Mr. Much then determined that due to the company's 1976 earnings decline that the discount should be increased to 20% because the company's ability to repurchase was reduced. The determination of appropriate discount is largely a subjective undertaking. In view of the courts finding that Mr. Much acted with obvious bias towards supporting the theory of the Department of Labor these valuation determinations are not persuasive.

regard, as the court sees it, is that the dip in revenues from that projected, coupled with the minority block transfer, should have signaled a reasonably prudent person to not rely on the Rotan Mosle appraisal. However, without an arm's length sale fair market value of a closely held corporation's stock cannot be ascertained with any degree of certainty. The court accepts the Rotan Mosle appraisal as the most certain approximation of the fair market value which can be obtained. Further, the court holds, in light of the foregoing discussion, that that appraisal remained a reasonable approximation of the value of the stock transferred to the ESOP in August of 1976 and February of 1977.

CONCLUSIONS OF LAW

This court has jurisdiction of this cause under section 502(e)(1) of ERISA, 29 U.S.C. 1132(e)(1). Venue is proper under section 502(e)(2) of ERISA, 29 U.S.C. 1132(e)(2).

The Secretary of Labor has the authority to bring this action under section 502(a)(2) and (5) of ERISA, 29 U.S.C. 1132(a)(2) and (5).

The MCS ESOP is an employee pension benefit plan within the meaning of section 3(2) of ERISA, 29 U.S.C. 1002(2). MCS is a corporation engaged in interstate commerce. Section 4(a)(1) of ERISA, 29 U.S.C. 1003(a)(1).

Each of the primary defendants is a fiduciary within the meaning of section 3(21)(A) of ERISA, 29 U.S.C. 1002(21)(A) and Defendant Cunningham is a party in interest with respect to the ESOP within the meaning of section 3(14)(A) of ERISA, 29 U.S.C. 1002(14)(A).

[12, 13] The Employee Retirement Income Security Act was designed to "prevent transactions which would dissipate or endanger plan assets; and to provide effective remedies for breaches of trust." U.S. Code Cong. and Admin. News pp. 4939, 5186, 93d Cong. 2d Sess., 1974. Applying the facts found above to the law of ERISA, the court concludes that reliance on the Rotan Mosle appraisal of June, 1975 coupled with the independent assessment of the company's potential was reasonable and prudent for individuals in the position of these members of the Administrative Committee of the MCS ESOP. Further because defendants acted in good faith and because Mr. Cunningham did not participate in the vote or decision concerning the purchase by the ESOP of the MCS stock, the two stock transactions were accomplished in compliance with the general procedure prescribed in ERISA § 3(18)(B), 29 U.S.C. 1002(18)(B) and the documents and instruments governing the plan. Section 404(a)(1)(D) of ERISA, 29 U.S.C. 1104(a)(1)(D). Where the procedure utilized was in compliance with that delineated in the statute and the Plan and where the consideration paid was not in excess of adequate consideration, one cannot but conclude that each defendant as fiduciary discharged his duties in the interest of the plan beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries with the care, skill, prudence and diligence required, in compliance with section 404(a)(1)(A) and (B) of ERISA, 29 U.S.C. 1104(a)(1) and (B).[10]

The general fiduciary obligations of section 404 of ERISA, 29 U.S.C. 1104, are supplemented by specific

10. See generally Hutchinson, *The Federal Prudent Man Rule Under ERISA*, 22 V. H. L. Rev. 15 (1976).

prohibitions of section 406 of ERISA, 29 U.S.C. 1106, which Congress enacted to prevent categories of transactions which offer a high potential for insider abuse of plans or loss of plan assets. *Freund v. Marshall & Ilsley Bank*, 485 F.Supp. 629, 637 (W.D. Wis. 1979), *Marshall v. Kelly*, 465 F.Supp. 341 (W.D. Okl. 1978).

[14] While Congress intended through the enactment of section 406 of ERISA, 29 U.S.C. 1106, to prevent certain transactions which have a high potential for detriment to an employee plan, a transaction of the sort which occurred in this case (the purchase of qualifying employer securities) is not prohibited if the acquisition was for adequate consideration. Section 408(e)(1) of ERISA, 29 U.S.C. 1108(e)(1).

[15] Defendants have the burden of proving that the consideration paid for the stock by the ESOP was not more than adequate consideration where exemption is sought pursuant to section 408(e)(1) of ERISA, 29 U.S.C. 1108(e)(1) from the prohibitions against dealing with a party in interest. The court determines that the defendants have met this burden.[11]

Because the stock was sold to the ESOP for no more than adequate consideration, the exception of section 408(e)(1) of ERISA, 29 U.S.C. 1108(e)(1) is present and the prohibitions imposed in section 406(a) and (b)

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11. Defendants have met this burden primarily through their credible testimony that significant contracts were imminent at the time of the sale to the ESOP and through the Rotan Mosle appraisal of June, 1975. Defendants also have presented the expert testimony of Mr. Allan Graber in support of the $200.00 per share value for August 1976 and February 1977. Mr. Graber's testimony is some evidence of the $200.00 figure, but the court has discounted the probative value of his testimony because it is apparent that his primary experience is not in evaluation of entities of this nature.

of ERISA, 29 U.S.C. 1106(a) and (b), against dealings with a party in interest, are inapplicable. Therefore, no defendant engaged in an unexpected prohibited transaction within meaning of section 406 of ERISA, 29 U.S.C. 1106.

The court has specifically found that no defendant breached his fiduciary responsibility imposed by ERISA and by the plan documents. Accordingly, Defendants Perrin and Carter did not violate section 405(a)(1) and (3) of ERISA, 29 U.S.C. 1105(a)(1) and (3).

The court concludes as a matter of law that the third-party actions, cross-actions and counterclaims brought by defendants Esparza, Fritcher, Perrin and Carter against Cunningham and MCS should be dismissed in view of the court's findings on the merits of this case. The court's findings on the merits renders moot the various third-party actions, cross actions and counterclaims brought by these primary defendants for indemnity in the event of a determination of liability under ERISA in the dominant suit. Defendants/counter-plaintiffs in these actions also seek attorney's fees and costs against Cunningham or MCS. In light of this court's ruling on the application for fees and costs against the Department of Labor the court will reserve ruling on these claims for fees and costs against Cunningham or MCS.

Additionally, the third party actions against Allied brought by defendant Cunningham, Hairell and Robertson in one instance and defendants Perrin and Carter in another instance shall be dismissed in view of the court's findings on the merits of this case. Allied's counterclaim and third-party claims for indemnity are also moot except for the claim for its attorney's fees and expenses pursuant to the indemnity agreements and its request for fees and

expenses pursuant to section 502(g) of ERISA, 29 U.S.C. 1132(g).

ATTORNEY'S FEES

A. *Applications by Primary Defendants*

[16] The court finds that the primary defendants should be granted their attorneys' fees, costs and other expenses pursuant to 28 U.S.C. 2412(a) and (b). The court will enter judgment for costs against the plaintiff for defendants pursuant to 28 U.S.C. 2412(a). The court will enter judgment for reasonable attorneys' fees and expenses for defendants against the plaintiff pursuant to 28 U.S.C. 2412(b). Though 28 U.S.C. 2412(a) and (b) accord discretion to the court in awarding attorney's fees, it is appropriate to delineate the bases for the determination that defendants should receive their expenses and fees. See *Iron Workers Local No. 272 v. Bowen*, 624 F.2d 1255 (5th Cir. 1980) (involving similar discretion under 29 U.S.C. 1132(g)).

The defendants individually and MCS suffered a devastating attack by the Department of Labor (DOL) in the bringing of this suit. Upon hearing the evidence presented by the DOL it is clear that this case could have been avoided if the DOL had taken a more objective look at the facts which were or could have been at their disposal. This court is further of the opinion that for whatever reason, which is not readily apparent, the case became a cause celebre in the eyes of the DOL and its attorneys. For example, the manner in which the services of Mr. Much were obtained, his apparent effort to build a case and the combative atmosphere of the pretrial period and trial to the court are significant indica-

tions of the motivations beyond that which may be reasonably expected in a suit to obtain compliance with the provisions of ERISA. The award of fees and expenses is appropriate not only because the DOL is able to satisfy the award or because the suit was largely unjustified, but also because this award might, to some degree, cause the DOL to take a more objective approach before instituting suits which have such significant adverse impact upon the lives of a relatively small but successful business and on the lives of hardworking individuals whose industry has resulted in gain for themselves and their employees.

The court further finds that Defendants Hairell, Carter, Perl[illegible], Robertson, Esparza and Fritcher qualify for recovery of thier reasonable attorneys' fees pursuant to 28 U.S.C. 2412(d)(1)(A), because these defendants were parties as defined in 28 U.S.C. 2412(d)(2)(B), and the position of the United States was not substantially justified. Judgments for fees and costs for all primary defendants will be entered accordingly.

B. *Application by Allied*

[17] The court has determined that the indemnity agreement contained in the Plan section 17G is void under section 410 of ERISA, 29 U.S.C. 1110. Allied argues persuasively that section 1110 of Title 29 does not apply to the indemnification agreement as to Allied because in this agreement MCS would be called upon to indemnify Allied and in such situation the agreements do not undermine the responsibilities imposed on Allied as directed trustee.

The Department of Labor issued an interpretive bulletin June 4, 1975 which is contained within 29 C.F.R.

2509.75 4. 29 C.F.R. 2509.75 4 provides in pertinent part:

> The Department of Labor interprets this section (29 U.S.C. 1110(a)) to permit indemnification agreements which do not relieve a fiduciary of responsibility or liability under Part 4 of Title I. Indemnification provisions which leave the fiduciary fully responsible and liable, but merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance purchased under section 410(b)(3), are therefore not void under section 410(a). . . . The Department of Labor interprets section 410(a) as rendering void any arrangement for indemnification of a fiduciary of an employee benefit plan by the plan. Such result would have the same result as an exculpatory clause, in that it would, in effect, relieve the fiduciary of responsibility and liability to the plan by abrogating the plans right to recovery from the fiduciary for breaches of fiduciary obligations . . .

In the instant case, of course, the ESOP owns a substantial portion of MCS stock. It is inconsonant with the intentions of section 410 of ERISA, 29 U.S.C. 1110, and the regulations quoted above, to permit indemnification by MCS where the ESOP would indirectly bear the financial burden. Such situation is not a mere shifting of liability incurred by a fiduciary in the same manner as insurance. Further that there is no adjudication of Allied's status as fiduciary does not affect the court's ruling on this question. The goal is to protect the ESOP from suffering any expense of this suit—that goal cannot be met by requiring MCS to indemnify any part to this suit. Similarly, the two letter agreements of August

1976 and February 1977 executed by the Administrative Committee may not be given affect under section 410 of ERISA, 29 U.S.C. 1110.

The court will not rule on the enforceability of the indemnity agreement of February 18, 1977 executed in favor of Allied by Kenneth R. Cunningham in view of this court's determination that fees and costs should be available under section 502(g)(1) of ERISA, 29 U.S.C. 1132(g)(1). This award under section 1132(g)(1) will be against Defendant Cunningham alone. The court has determined that the award is appropriate in such form because the third party actions against Allied were unfounded and were designed it appears only to secure Allied's presence in the suit to aid in defense of the primary suit. Further, Cunningham is in the financial position to satisfy the award of fees and costs while the other defendants are not.

[18] The statutory construction of ERISA makes clear that the responsibility of Allied as directed trustee is not equal to that of primary fiduciaries. Section 403(a)(1) of ERISA, 29 U.S.C. 1103(a)(1) provides that a trustee such as Allied is to follow the "proper directions" of a named fiduciary which directions are made in accordance with the terms of the plan and which are not contrary to ERISA. This court, while acknowledging differentiation in standards of care implied by section 1103, carried Allied's motion for summary judgment through the trial because the reach of ERISA to entities performing services for the ESOP is quite long. Notwithstanding the limited role prescribed by section 1103, the trustees actual exercise of authority or control could raise the fiduciary responsibility required of such trustee. Section 3(21)(A)

of ERISA, 29 U.S.C. 1002(21)(A). However, it became apparent upon hearing the evidence at trial and upon a review of the depositions of the various principals, that Allied at all times remained within the limited role of directed trustee. Award of its costs and fees is therefore appropriate.

The fees and costs allowed pursuant to this order will be determined at hearing.

Accordingly it is hereby ORDERED, ADJUDGED, and DECREED:

(1) That the Department of Labor's claims brought under sections 404 and 406 of ERISA, 29 U.S.C. 1104, 1106 against Defendants Cunningham, Esparza, Fritcher, Hairell, and Robertson be and same are DISMISSED with prejudice and that judgment be entered for these defendants.

(2) That the Department of Labor's claim against Defendants Perrin and Carter under section 405 of ERISA, 29 U.S.C. 1105 be and same is DISMISSED with prejudice and that judgment be entered for these defendants.

(3) That the third party actions, cross-actions and counterclaims brought by Defendants Esparza, Fritcher, Perrin, and Carter, against Defendant Cunningham and Metropolitan Contract Services, Inc., be and same are DISMISSED.

(4) That the third party actions against Allied Bank of Texas brought by Defendants Cunningham, Hairell, Robertson, Perrin, and Carter be and same are DISMISSED.

(5) That the counterclaim and third party claims of Allied Bank of Texas against Metropolitan Contract Services, Inc., the Metropolitan Contracts Services, Inc., Employee Stock Ownership Plan, Cunningham, Hairell, Robertson, Perrin, and Carter be and same are DISMISSED save and except Allied's application for attorney's fees and costs against Cunningham pursuant to section 502(g)(1) of ERISA, 29 U.S.C. 1132(g)(1).

(6) That Defendants Cunningham, Esparza, Fritcher, Hairell, Robertson, Perrin, and Carter shall have their costs and attorneys' fees incurred in this action pursuant to 28 U.S.C. 2412(a) and (b).

(7) In the alternative, that Defendants Esparza, Fritcher, Hairell, Robertson, Perrin, and Carter shall have their costs and attorneys' fees from the Department of Labor, pursuant to 28 U.S.C. 2412(d)(1)(A).

(8) That Allied Bank of Texas as counter-plaintiff and third-party plaintiff shall recover from Cunningham, its attorneys' fees and costs incurred against Cunningham pursuant to section 503(g)(1) of ERISA, 29 U.S.C. 1132(g)(1).

APPENDIX E

STATUTES INVOLVED

29 U.S.C. § 1002. Definitions

For purposes of this subchapter:

* * *

(18) The term "adequate consideration" when used in part 4 of subtitle B of this subchapter means (A) in the case of a security for which there is a generally recognized market, either (i) the price of the security prevailing on a national securities exchange which is registered under section 78f of Title 15, or (ii) if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest; and (B) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

* * *

29 U.S.C. § 1104. Fiduciary duties

(a)(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

* * *

29 U.S.C. § 1106. Prohibited transactions

(a) Except as provided in section 1108 of this title:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 1107(a) of this title.

* * *

29 U.S.C. § 1108. Exemptions from prohibited transactions

* * *

(e) Sections 1106 and 1107 of this title shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 1107(d)(5) of this title) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in section 1107(d)(4) of this title)—

(1) if such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under section 1107(e)(1) of this title),

(2) if no commission is charged with respect thereto, and

(3) if—

(A) the plan is an eligible individual account plan (as defined in section 1107(d)(3) of this title, or

(B) in the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section 1107(a) of this title.

* * *

APPENDIX F

LETTER FROM DEPARTMENT OF LABOR TO G.A.O., dated March 18, 1980

U. S. DEPARTMENT OF LABOR
Inspector General
Washington, D.C. 20210

March 18, 1980

Mr. Gregory J. Ahart
Director
Human Resources Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Ahart:

This is in reply to your letter to Ray Marshall, Secretary of the United States Department of Labor, requesting comments on the draft GAO report entitled, "Employee Stock Ownership Plans: Who benefits most in closely held companies—employers or employees?"

The Department's responses are enclosed.

The Department appreciates the opportunity to comment on this report.

Sincerely,

/s/ MAJORIE FINE KNOWLES
Marjorie Fine Knowles
Inspector General

Enclosures

U. S. Department of Labor's Response To The Draft General Accounting Office Report Entitled, "Employee Stock Ownership Plans: Who benefits most in closely held companies—employers or employees?"

Recommendation: The Secretary of Labor should develop and promulgate through regulations and implementing procedures, more specific criteria and guidelines for valuing stock of closely-held companies.

Response: The Department concurs.

Comments: The Department of Labor has previously provided guidance on the valuation of stock for which there is no generally recognized market. In a speech before the ESOP Council of America on May 7, 1979, Ian D. Lanoff, Administrator, Pension and Welfare Benefit Programs, reiterated the Department's position that a fiduciary should make a good faith determination with respect to the fair market value of stock by utilizing recognized methods of valuing stock in closely-held corporations. Mr. Lanoff further noted that the factors outlined in Revenue Ruling 59-60 should assist the plan fiduciary in making valuation determinations.

Although the myriad of factual situations precludes the development of a precise method of determining adequate consideration in the case of ESOP purchases of employer securities, the Department remains committed to the development of standards for plan fiduciaries making valuation determinations. The Department hopes to develop more specific guidelines for valuing the stock in closely-held companies as our experience in the ESOP area grows.

The Department wishes to note that it is currently in the process of considering whether to formally adopt the guidelines contained in Revenue Ruling 59-60 for the valuation of qualifying employer securities for which there is no generally recognized market under section 3(18) of ERISA.

U. S. Department of Labor's Response To The Draft General Accounting Office Report Entitled, "Employee Stock Ownership Plans: Who benefits most in closely held companies—employers or employees?"

Recommendation: That the Secretary of Labor promulgate regulations to require plan provisions for redeeming, at fair market value, all company stock distributed by an ESOP.

Response: The Department does not concur.

Comments: Regulations issued by the Department under the definition of an ESOP contained in section 407(d)(6) of ERISA require that employer stock acquired by an ESOP with the proceeds of an exempt loan must be subject to a put option if it is not publicly traded at the time of distribution. It is the Department's view that ERISA does not confer similar authority to require put options under all circumstances involving the distribution of closely-held employer stock by an individual account plan designated an ESOP. Congress, in enacting the Revenue Act of 1978, amended the Internal Revenue Code to require that participants receiving a distribution of employer stock from a TRASOP or a leveraged ESOP must generally be given a put option in the case of an employer whose stock is not publicly traded at the time of distribution. It would appear that further legislative action would be necessary in order to impose additional plan provisions pertaining to the redemption of all closely-held employer stock distributed from an ESOP.

U. S. Department of Labor's Response To The Draft General Accounting Office Report Entitled, "Employee Stock Ownership Plans: Who benefits most in closely held companies—employers or employees?"

Recommendation: To carry out the Congress' intent to guard against potential abuse of ESOPs by parties-in-interest, we recommend that the Secretaries of Labor and Treasury develop and implement a program for providing special scrutiny of ESOP transactions.

Response: The Department does not concur.

Comments: The Department is of the view that its past programs have provided the special scrutiny mandated by Congress and that present programs continue to assure that such scrutiny will be provided in the future. Within the constraints of its limited resources, the Department's activities in this area, since the passage of ERISA on September 2, 1974, have included the following:

* The Department has opened over 150 cases on ESOPs, 42 of which are presently pending.

* Of these cases, four have resulted in litigation. Since, in total, the Department has brought approximately 40 lawsuits alleging violations of ERISA, the number of lawsuits involving ESOPs represents approximately 10% of all suits filed. One additional lawsuit is contemplated in the near future and others are under active consideration by the Office of the Solicitor.

* The Kansas City Region of LMSA, the Region containing the most LMSA area offices, instituted a special targeting effort concentrating solely on ESOPs.

ESOPs are the only type of employee benefit plan which has ever been singled out for such special targeting. As a result of this project, 27 ESOPs were investigated in depth.

* Investigative and auditing guidelines designed specifically for examining ESOPs have been developed. These guidelines have been distributed throughout the program for use in investigations of ESOPs.

With regard to ESOP investigations, the main issue usually confronting DOL auditors is the proper valuation of employer securities. The issue, therefore, has been the primary focus of all Departmental activity with regard to such investigations. As stated by Ian Lanoff, Administrator of the Pension and Welfare Benefit Programs, in a speech on May 7, 1979 to the ESOP Council of America:

> We place great importance on the process of determining the value of the securities in the ESOP context because the purchase or sale of employer securities by the Plan may directly benefit those persons responsible for the investment decision and because adequate consideration is more difficult to determine because the stock may not be publicly traded or may not have a generally recognized market.
>
> A problem common to several ESOPs which has come to the attention of the Department is the failure of plan fiduciaries to take sufficient steps to determine the value of the securities prior to the purchase.

This emphasis has also been reflected in the activities of the ERISA Advisory Council of the Department of Labor. The investment and fiduciary responsibility work group

of that Council, recognizing the importance of ESOPs, undertook a detailed study of the Department's activities in this area. In its report to the full Advisory Council, on November 7, 1979, the committee recommended that: "The Department be commended for its enforcement focus in the ESOP context on 'adequate consideration' for, and proper valuation of, employer securities. . . ."

The Department's emphasis in this area is continuing. With regard to staff training, internally, LMSA is developing a two week long course in investments one of the main focuses of which is valuation of employer securities. Externally, the Department has recently had three of its supervisory personnel attend a pilot valuation training program developed by the IRS. The Department contemplates that additional employees will attend future sessions of this course as it is offered.

As indicated by the Kansas City Pilot Program, it is possible to successfully target ESOPs for investigation. However, to increase the Department's ability to select plans for such investigations, changes have been made in the Form 5500 series for the year 1979. For the first time, this form includes specific questions relating to ESOPs. Question 19(c) is as follows:

> (c) Is this a plan with Employee Stock Ownership Plan (ESOP) features?
>
> (i) If "yes," was a current appraisal of the value of the stock made immediately prior to the contribution of the stock or the purchase of the stock by the trust?

(ii) If (i) is "yes," was the appraisal made by an unrelated third party?

(iii) If (ii) is "no," was the appraisal made in accordance with provisions of a Revenue Ruling 59-60?

It is anticipated, when responses to the 1979 Form 5500 series are received that this item (as well as other items) will be computer scrutinized as part of the Department's ongoing program of targeting plans for future investigations.

In the past, it has been through such analysis of reports filed with the Department that most investigations have been instituted. For example, of the 20 investigations listed in our memorandum to you of July 11, 1979, only five were generated by a participant complaint. Two were referred to us by other Governmental agencies and the other 13 were generated internally based on reviews of reports filed by the plans.

In conclusion, it is the Department's view that it has, within the constraints imposed by its available resources, fully complied with its congressional mandate to provide special scrutiny to ESOPs. In the past, this special scrutiny has taken the form of a major special project devoted solely to the investigation of ESOPs, the opening of cases on over 150 such plans, and the filing of four lawsuits. In the future, this special scrutiny will continue to exist in the form of additional lawsuits, increased training of LMSA personnel with regard to stock valuation, and special emphasis on targeting potential abuses through new reporting requirements in the 1979 Form 5500 series.

APPENDIX G

IRS's TECHNICAL ADVICE MEMORANDUM AND MEMORANDUM OF WITHDRAWAL

Section 6110 Weekly Index 1982

Aug. 2, 1982

* * *

IRC Section	Subject	Ref. No.
4975	Good faith is defense to imposition of prohibited transaction tax when sales price of employer securities to ESOP exceeds fair market value	8231002

National Office Technical Advice Memorandum

ISSUES:

1. Whether good faith is a defense to the imposition of the prohibited transaction tax on a principal shareholder where the sales price of employer securities to a qualified plan exceeds its fair market value?

2. Whether the formula in Section 16 of Plan X, dealing with the repurchase of employer stock by Company M from terminated participants, binds the Service to this same formula for purposes of valuing employer stock purchased by the trust from the principal shareholder, other than in his capacity as a Plan X participant.

FACTS:

Plan X is an employee stock ownership plan (ESOP). Plan X's effective date was January 1, 1972. Plan X has been amended to conform to ERISA and received a favorable determination letter on April 4, 1977.

Section 16 of Plan X provides that at the time shares of Company M stock are distributed, a participant shall be granted an option to "put" the shares to Company M or the Trust. A "put" option shall provide that a participant shall have the right to have Company M or the Trust purchase such shares at their net book value.

Section 6 of Plan X, with regard to the investment of Trust assets, provides that all purchases of Company M stock shall be made at prices which do not exceed the fair market value of such shares, determined in good faith.

Plan X purchased Company M common stock from Mr. A during the years 1973-1977. The stock was purchased in accordance with the following valuation formula:

> Net worth of employer plus or minus unrealized appreciation or depreciation of the corporation's marketable securities.
>
> Number of shares outstanding

Company M relied on an independent valuation done by Company N, an investment banking firm, in arriving at the above valuation formula.

At the time Company N made the first appraisal (December 1973), the value of each share of Company M stock was established at $1,153, while earnings per

share for the period ending December 31, 1974, were $157. In 1975 the earnings per share were only $98, yet the price paid for the shares sold to Plan X by Mr. A had increased to $1,333.

LAW:

Section 4975(d)(13) of the Internal Revenue Code provides that the prohibitions in section 4975(c) (relating to the definition of the term "prohibited transaction") shall not apply to any transaction which is exempt from section 406 of ERISA (relating to the definition of prohibited transactions) by reason of section 408(e) of ERISA. Section 408(e) of ERISA states, in part, that section 406 of ERISA shall not apply to the acquisition or sale by a plan of qualifying employer securities if such sale is for adequate consideration. Adequate consideration is defined in section 3(18) of ERISA as, in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor.

The Secretary of Labor has not issued regulations defining "fair market value" or "good faith" for purposes of section 3(18) of ERISA.

Section 54.4975-11(d)(5) of the Income Tax Regulations, relating to the valuation of employer securities purchased by an ESOP, states, in relevant part, that valuations must be made in good faith and based on all relevant factors for determining the fair market value of the securities. An independent appraisal will not in itself be a good faith determination of value in the case of a

transaction between a plan and a disqualified person. However, in other cases, a determination of fair market value based on at least an independent appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any party to the transaction will be deemed to be a good faith determination of value.

Revenue Ruling 59-60, 1959-1 C.B. 237, outlines the factors and methods to be considered in valuing shares of stock of closely held corporations for estate and gift tax purposes. Section 5 of the ruling provides that earnings may be the most important criterion of value in some cases, whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

RATIONALE:

"Good faith," as used in section 3(18) of ERISA and section 54.4975-11(d)(5) of the regulations, is a defense against the imposition of the prohibited transaction tax on the finding of an overpayment by a plan for the purchase of employer securities from a disqualified person. Therefore, in the present case, assuming there is a prohibited transaction because of an overvaluation of Company M employer stock, and assuming Mr. A can show that the valuation was done in good faith, the prohibited transaction tax should not be imposed. "Good faith" is a defense against (and an exception to) the finding of a

prohibited transaction. It can serve no other purpose. A lack of "good faith" will not render a proper valuation invalid. Good faith does, on the other hand, cure an improper valuation. We are not addressing the issue of whether the valuation of Company M shares sold to Plan X was made in good faith. A determination of whether good faith was present, is not possible without knowing whether the valuation method was appropriate and how much, if any, the stock was overvalued.

Because we have stated that good faith is a defense to the imposition of a prohibited transaction tax in the case at hand, and because we do not know whether Company M's stock has been overvalued and whether it was done in good faith, we are unable to find that a prohibited transaction took place. Until there is a finding that a prohibited transaction took place, we will not answer issue two because it assumes a prohibited transaction.

CONCLUSION:

Good faith is a defense to the imposition of the prohibited transaction tax on a principal shareholder where the sales price of employer securities to a qualified plan exceeds its fair market value.

* * *

INTERNAL REVENUE SERVICE
MEMORANDUM

8304003

September 27, 1982

District Director

Chief, EP/EO Division

Director, Employee Plans Division OP:E:EP

On March 23, 1982, the National Office issued a memorandum of technical advice on the above-described case. That technical advice is hereby withdrawn. The conclusion is being reconsidered, and you will be advised when we have developed a position on the matter. Please return the case files to the National Office, Attention: Mr. Allen Katz, Employee Plans Technical Branch, Room 6556, as soon as possible for use in our reconsideration.

It means only that the technical advice provided may not be used in any way in disposing of cases involving this taxpayer or any other taxpayer.

Refers to Written Determination No. 8231002